

Technical Appendices

Appendix I – Land Use and Planning

Bay Area Economics. Retail Impact Market Analysis for Proposed Retail Shopping Center in Morgan Hill, CA. June 2005.



**PUBLIC REVIEW DRAFT
RETAIL MARKET IMPACT ANALYSIS
FOR
PROPOSED RETAIL SHOPPING CENTER
IN MORGAN HILL, CA**

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City of Morgan Hill

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June, 2005

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Executive Summary

Background and Study Purpose

DiNapoli Browman Guglielmo Development has submitted a proposal to the City of Morgan Hill for a large new retail center. The City of Morgan Hill has retained Bay Area Economics (BAE) to undertake an economic impact analysis as part of the EIR process for this project. BAE aims to use the best available information to assess the economic impacts and then establish whether these economic impacts might result in a negative effect on the physical environment of Morgan Hill as manifested by urban decay and physical deterioration of existing retail centers.

Project Description

The retail project (as yet unnamed, referred to in this report as the “Proposed Project”) is proposed as an approximately 650,000 square-foot retail center at the Cochrane Road exit from U.S. Highway 101, to the east of the highway and the north of Cochrane Road. The Proposed Project consists of a mix of retail space configurations in several large buildings and free-standing pads, including two anchor spaces of more than 100,000 square feet, a movie theater complex of 63,200 square feet, additional store space ranging from 4,000 to 30,000 square feet, and several pad spaces suitable primarily for fast-food restaurants. At this time, the committed tenant is Target, slated to be a major anchor in a 123,800 square-foot space. A large anchor space adjacent to Target is configured for a large home improvement store, but no retailer is committed to this space. An alternative for the site plan has a 50,000 square-foot food store taking space currently shown as separate 20,000 and 30,000 square-foot spaces. A fuel station is shown as an alternative for a 6,000 square-foot pad.

The developers have expressed an interest in developing this project as a “lifestyle center,” with an emphasis on higher-end stores, dining, and entertainment (as indicated by the movie theater complex), creating a destination retail experience that might draw shoppers and movie-goers from outside Morgan Hill. However, at the time of this analysis there are no committed tenants in these categories.

Definition of Trade Areas

The Target Trade Area has been defined as the area from which the Target anchor tenant is likely to draw most of its customers and is bounded based primarily on the location of other Target stores nearby, on the assumption that shoppers will go to the Target closest to their residence. The Target Area consists primarily of Morgan Hill and surrounding unincorporated areas, but also includes the Coyote Valley area of San Jose. This Trade Area is also used for most of the other center tenants, including the undefined retail uses, since there are no commitments at this time from specific tenants whose market area might not be constrained by the significant region-serving retail concentrations in Gilroy and San Jose.

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The Cinema Trade Area has been defined based on the area likely to provide most of the customers for a multiscreen theater complex as proposed. The Cinema Trade Area encompasses all of the Target Trade Area and extends south through Gilroy to the Santa Clara County borders with Santa Cruz and San Benito Counties. To the north, while a large new complex in a well-designed center would garner some movie-goers from San Jose, the major theater complexes in South San Jose will still capture most of the customer base due to their proximity. To the south, the presence of other screens in Hollister and Watsonville as well as sheer distance will preclude the capture of significant numbers of customers.

Summary of Demographic and Economic Overview

The Target Trade Area is undergoing moderate population and household growth, keyed largely to the residential growth caps in place in Morgan Hill. It is estimated the Target Trade Area will have a population of 53,486 and 17,117 households by 2010. The Cinema Trade Area has shown stronger growth, based on the faster growth rate of Gilroy. The Cinema Trade area is expected to reach an estimated 115,888 persons and 35,178 households by 2010. Long term, these trends are expected to continue, with Gilroy's growth outpacing Morgan Hill's.

A key factor affecting long-term population growth potential in the Trade Area is the development of Coyote Valley in San Jose. Current plans call for 50,000 "driving industry" jobs and 25,000 total residential units housing 80,000 people. Along with a stable fiscal condition for the City, job creation is the "trigger" for City adoption of the Specific Plan, which will then allow other uses to move forward. As currently envisioned, Coyote Valley will not have any region-serving retail; if the final plans maintain this pattern, it could considerably benefit Morgan Hill in drawing customers seeking region-serving retail and trying to avoid congestion elsewhere in San Jose. However, in the current slow job market in San Jose, market analysis completed for the City indicates that total jobs will not reach 5,000 until 2012, at which point limited residential development can commence. Full buildout is not expected for 30 to 40 years. Recently San Jose's Mayor has suggested that residential development should be permitted first. At this time, no approvals (including amending San Jose's General Plan) have been given for this approach, so the analysis here assumes that the current planning process will move forward. Any change in development timing or relaxing of the job creation "trigger" is speculative at this time. This report assumes that substantial development in Coyote Valley will be a long-term prospect, and is unlikely to be a source of retail customers for Morgan Hill in the time frame of this analysis.

The Target Trade Area and to a lesser extent the Cinema Trade Area exhibit strong demographics for retail trade, with high home ownership and high household incomes in comparison to the state. However, the regional economy has been in a sustained downturn following the collapse of the high-tech economy, with a decline in employed

residents in Santa Clara County in every year since 1999. This has been reflected in declines in retail sales in the county.

Commuter flows indicate that Morgan Hill has more employed residents than jobs. Nearly three-fourths of the city's workers commute in from elsewhere, but the potential for additional dollars to be captured with an increase in retail is extremely limited.

Because of the demographic profile for the Trade Areas, Morgan Hill is well-suited for family-oriented retail geared toward households with moderate to high incomes. Target is geared toward this market, and lifestyle retail may also be well-suited, if the population base is sufficient to support it.

Summary of Retail Sales Trends

Historic retail sales trends in south Santa Clara County can be seen as a "Tale of Two Cities," with Morgan Hill's retail sales trends in stark contrast to sales trends in nearby Gilroy. Morgan Hill's retail sales have not kept pace with population, unlike Gilroy's. Morgan Hill per capita retail sales are actually below countywide levels, a strong indicator of retail leakage. In contrast, Gilroy's per capita sales are far above countywide levels, with the gap increasing over time, showing Gilroy's strengthening position as a regional retail destination.

Morgan Hill retail sales trends have matched the downward trend countywide of the last few years in the general merchandise, food store, building materials, and restaurant categories, although the opening of Home Depot in 2004 has led to a sharp increase in sales in the building materials store category. Sales data from 2004 also indicate a sharp drop in general merchandise store sales following the opening of Gilroy's Costco early in 2004 and the Target and Kohl's in Gilroy Crossing prior to the holiday shopping season that year. Gilroy has shown a steady increase in all of these categories, with the exception of food stores, where sales levels are more closely tied to the local population and its growth.

The Target Trade Area can support additional retail in most relevant retail categories for a large retail center, with potential capture of approximately \$88 million in sales leakages and an additional \$34 million in growth through 2010, supporting 378,000 square feet of new retail space. However, the additional sales in some categories, including building materials stores, bookstores, and home appliance stores, is not enough to support large-format national chain retail stores. One exception to this is office supply stores. The limitations of local demand in combination with the large size requirements for national retailers further exacerbates Morgan Hill's weakness in competing with Gilroy, which has a larger and more quickly growing population base, and can more easily capture additional sales from San Benito County to the south.

The developers have stated that they are seeking to position this center as a "lifestyle center," providing a shopping experience unique to Morgan Hill with a combination of

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entertainment, dining, and upscale tenants. With the presence of two big-box anchors, the entire center could be classified as “hybrid center” with lifestyle components and components typical of more conventional shopping centers. Such a center might draw from beyond the Target Trade Area, but would have to draw from a very broad area to match the population base of two major existing lifestyle centers in the Bay Area, Santana Row and Bay Street. In any case the other tenants in the Proposed Center have not been designated, so this economic impact analysis assumes a more generic tenant mix, with many of the tenants in an overall unspecified category. With the exception of the movie theater complex, the analysis assumes that demand will come from the Target Trade Area for potential tenants other than the movie theater complex, since at this time it cannot be assumed with certainty that the other tenants will have a broader regional draw. If the Proposed Project succeeds in signing tenants fitting the upscale lifestyle center profile, they may attract significant numbers of shoppers from a larger area, lessening some of the impacts discussed here.

Summary of Retail Impacts Analysis

The Proposed Project represents a significant increase in the amount of retail space in Morgan Hill, with a center size larger than any of the existing centers. The most apparent immediate impact will be the creation of a large vacant space in Cochrane Plaza due to the relocation of Target to the proposed project. Among other retail categories, the opening of a new home improvement style store similar to but larger than Home Depot may lead to market saturation in Morgan Hill and the Target Trade Area, which does not have a sufficient customer base to support two such stores at industry average performance levels. The opening of a major multiplex will create overcapacity in both Morgan Hill and the Cinema Trade Area, with the impacts likely to be greatest in Morgan Hill. Additional restaurant retail might be supportable, and the overall performance at the local supermarkets is strong enough that another competitor might enter the market, especially if it has a more region-serving focus.

The impacts would be lessened to some degree if the Proposed Project is successfully positioned as a lifestyle center and serves a broader market area. However, market areas for the two largest users of the proposed project (general merchandise and home improvement) face significant competition outside Morgan Hill from existing and planned general merchandise stores and home improvement warehouses in Gilroy and San Jose. Movie theaters might draw from a larger area due to their convenient highway location and large number of offerings available due to the number of screens. However, the Proposed Project adds more screens than are supportable in a larger area, doubling the number of screens in the Cinema Trade Area.

The most obvious local impact will be at Cochrane Plaza, where the Target anchor will be relocating to the project and vacating the center. The loss of Target is likely to lead to reduced traffic at the other stores in the center, many of which are complementary to the Target, offering similar apparel and household items. Some of these tenants may choose to move to the new center to remain close to the Target and the customer traffic it

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generates. The restaurants such as McDonald's in Cochrane Plaza will also face new nearby competition from restaurants at the Proposed Project, which is likely to capture some of their share of pass-by highway traffic looking for convenient dining or takeout even as it captures new pass-by traffic and regional business generated by a movie theater complex.

The Lawrence Oaks Center could be significantly impacted if the Proposed Project includes a large home improvement store as planned. As discussed above, the local trade area is not capable of supporting two large home improvement stores performing at industry average sales levels. However, this center's two anchors, Safeway and Home Depot, are not particularly complementary and thus the loss of either is not likely to significantly affect the other. In fact, the Safeway and an adjacent Longs Drugs continued to operate successfully after the Kmart previously occupying the Home Depot space closed. Furthermore, since this center is not as focused as Cochrane Plaza, re-tenanting may not prove as difficult, with one possibility being an office supply store, a category for which Morgan Hill shows significant additional capturable sales.

Tennant Station could ultimately see the loss of the Cinelux movie theater complex if the new multiplex opens as proposed, since the Cinema Trade Area's population base does not support additional screens. The major anchors, Safeway and Rosso's Furniture, however, report strong sales, and the loss of a movie theater would not likely impact their sales significantly; nor are these two anchors at risk from the Proposed Project.

The analysis indicates that the other retail nodes in Morgan Hill are not likely to lose major tenants or stores and thus will not be impacted in a way that might lead to urban decay or physical deterioration. With respect to downtown, the Proposed Project serves a different niche for both consumers and retailers in Morgan Hill, and as such, should not see major impacts from the Proposed Project.

The one under-construction, planned, or proposed development of significance with respect to potential cumulative impacts is the Wal-Mart Supercenter in Gilroy, slated for opening later this year. The addition of a full grocery department to the store will capture supermarket sales going to competitors in Gilroy, Morgan Hill, and elsewhere, with stores in Gilroy bearing the brunt of the impact due to their proximity. The additional sales likely to be captured from Morgan Hill stores in combination with a grocery store at the Proposed Project would not be likely to lead to closures, as each of the major supermarkets is performing at levels capable of sustaining this level of additional sales loss, assuming the losses are shared somewhat equally. The vacancy created by Wal-Mart's closure of their existing store is another significant retail real estate event related to the opening of the Supercenter. As an older existing space designed for a certain user, it is unlikely to attract the kinds of prime tenants seeking new space in a center such as the Proposed Project. However, mitigation measures required as part of the approvals for the Supercenter require the demolition of this space if it is not re-leased within a certain period of time.

Conclusions Regarding Urban Decay and Physical Deterioration

The analysis considered the potential for urban decay and physical deterioration for each of the competing Morgan Hill retail nodes, taking into account the impacts of the Proposed Project and possible cumulative impacts due to other retail development in Morgan Hill, South San Jose, and Gilroy. No large anchor retail spaces are currently vacant in Morgan Hill, and BAE's tour of the existing centers found no current evidence of urban decay or physical deterioration resulting from vacancy, deferred maintenance, or disinvestment. None of the existing centers could be seen as being at risk of urban decay if the Proposed Project is not built.

Cochrane Plaza. The proposed center will lead to the loss of one of two large anchors at Cochrane Plaza. This center and its other large anchor, Mervyn's, face strong new competition from Gilroy Crossing and its new Target and Kohl's. Mervyn's faces an uncertain future following its sale in 2004 by the Target Corporation, with some indications that the underlying value is in its real estate holdings rather than in its operations. At this time, however, the new ownership has continued with existing management and has not announced any major changes such as store closures. A representative of Cochrane Plaza indicated that other stores in the center are faring poorly even with the existing Target in place, with prospective tenants for a vacant space reportedly requesting a cancellation clause if the Target closes. Other tenants may close entirely or relocate to the Proposed Project seeking the continued synergy of locating near a Target. Cochrane Plaza is further constrained by land use regulations that do not allow re-tenanting of the Target space as a grocery store without voter approval. Re-leasing of the Target space might also require a subdivision or redevelopment of the existing store, as the market analysis indicates no support for a space of that size for any category of retail outlet. One possible reuse for at least part of the space is as an office supply store; the analysis indicates support for a sizable store in this category in Morgan Hill. However, this use does not complement the remaining tenant base nearly as well as Target, would not fill the entire vacant Target space, and might be more suitable for another location in Morgan Hill; if the Proposed Project seeks additional tenants outside the lifestyle retail niche, an office supply store could even be located there. Another factor to consider is the multiple ownership of this center; any attempt to redevelop the entire center must be approved by the separate owners of the vacated Target space (currently owned by Target), Mervyn's, and the owner of the remainder of the center. Given the lack of viable large-scale tenants for the Target space, the loss of synergy with the remaining tenants if the Target closes, and an uncertain future for Mervyn's, the center is likely to undergo secondary closures of smaller businesses. Therefore, Cochrane Plaza faces the possibility of entering a cycle leading to urban decay and physical deterioration resulting from long-term vacancies, secondary business closures, and the inability to re-tenant existing stores.

The actual potential for physical deterioration to occur will be dependent on the commitment from the current property owners to maintain the property, which will be

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made more challenging due to the multiple ownerships. Although it may be reasonable to assume that the owners would maintain the plaza in a condition suitable for re-tenanting, there is no evidence or indication that such upkeep would continue indefinitely in the face of long-term vacancies under oversaturated market conditions if the prospect of significant re-tenanting of the existing spaces is remote. Therefore, it is concluded that there is a high likelihood that the Cochrane Plaza would be subject to a causal chain ultimately resulting in urban decay. This potential for urban decay may be reduced or avoided through mitigation measures discussed below.

Lawrence Oaks Center. If the Proposed Project includes a home improvement center, it could result in market saturation in this retail sector, leading ultimately to closure of Home Depot. However, Home Depot and its largest competitor, Lowe's, are currently in a phase of opening stores to gather additional market share. Any consolidation and elimination of unprofitable stores may be several years away. This center survived the closure of its Kmart store, with the other anchor store, Safeway, as well as the Longs Drugs sustained by a customer base not driven by synergies with Home Depot. As a result, this center is unlikely to enter a cycle of additional vacancy leading to urban decay, even if the Home Depot is closed in a future consolidation of stores by its parent company.

Tennant Station. The main occupant at risk in Tennant Station is the Cinelux theatre complex, since the market area does not appear to be able to support additional screens in Morgan Hill. However, the two primary anchors of this center are a Safeway and a furniture store, neither of them at significant risk of closure due to the Proposed Project or other known future retail development. Additionally, the bowling alley is now slated for reopening later this year. This center has undergone major changes over the last several years, including the departure and reopening of Safeway, that indicate that vacant spaces will see reuse rather than long-term vacancy and decay.

Other Retail Nodes. For the other major retail nodes discussed above (Vineyard Town Center, Morgan Hill Plaza, the Nob Hill Center, and Downtown) the analysis does not indicate significant economic impacts related to the Proposed Project. As a result urban decay and physical deterioration are also not indicated as secondary impacts.

Mitigation Measures to Reduce or Avoid Potential Urban Decay

BAE recommends the following mitigation measures to lessen the potential for urban decay and physical deterioration.

General Mitigations. These measures are recommended to be implemented either citywide or for all potentially impacted retail nodes.

1. *Ordinances to enforce maintenance to prevent urban decay/physical deterioration of vacant retail spaces.* The analysis above indicates that there is a likelihood of closure for major tenants in Lawrence Oaks (Home Depot), Tennant Station (Cinelux theater

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complex), and Cochrane Plaza (Target, with the likelihood of other tenants following). If these centers (or others) face vacancies following the opening of the Proposed Project, the City of Morgan Hill will monitor maintenance of the vacated spaces and their centers for the first signs of disinvestment or deterioration, and require that these properties continue to be maintained to standards as stated in Section 15.56.020 of the Morgan Hill Municipal Code, such that the building will not endanger life, limb, health, property, safety, or welfare of the general public or its occupants. These standards are based on the International Conference of Building Officials “Uniform Code of the Abatement of Dangerous Buildings, 1997 Edition,” except where otherwise noted in the Section 15.56.020 of the Morgan Hill Municipal Code. The property shall be maintained in accordance with Morgan Hill Municipal Code Section 8 regarding Health and Safety, including but not limited to keeping premises free of litter, weeds, graffiti, and abandoned vehicles.

2. *Funding of programs to assist small retail businesses in Morgan Hill.* To help small local businesses compete with likely national chain retailers in the Proposed Project, the City will fund programs aimed at assisting locally-owned small retailers. This could take the form of a business seminar sponsored by Target and the project developers to educate local retailers, or other programs geared toward small retail business assistance, such as a kiosk at the Proposed Project providing information on shopping opportunities in Downtown Morgan Hill or other centers. Such a program could be funded by the City committing a percentage of the sales tax revenue generated by the Proposed Project.

3. *Utilization of Redevelopment Agency Resources.* The City of Morgan Hill will ensure the Target Corporation, the other owners of Cochrane Plaza, and the owners of Tennant Station, Vineyard Town Center, and the Lawrence Oaks Shopping Center are aware that their centers are in the City’s Redevelopment Area, and as a result they are eligible to apply for programs administered by the City’s Business Assistance Division, including the Facade Improvement Program, Impact Fee Financing Programs, and Business Assistance Guidelines.

Cochrane Plaza. The following mitigations are specific to Cochrane Plaza and the existing Target store slated for vacancy.

1. *Maintenance of Vacant Target Store.* As a condition of approval for the Proposed Project, the Target Corporation will make a written commitment, using a mechanism such as a restriction or notice on their deed to the existing store property, to maintain their vacated existing store per the guidelines set out above regarding abatement of physical decay and deterioration of buildings per the Morgan Hill Municipal Code. This maintenance will include but not be limited to prompt removal of trash and graffiti and upkeep of the vacant building to leasable standards for a modern community shopping center. This commitment will extend to successors in ownership if the Target Corporation sells the property prior to re-tenanting. This commitment will extend until a majority of the space in the vacant store is re-occupied for a period of at least 12 consecutive months.

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2. *Facade Easement.* As an additional measure to assure proper maintenance of the vacated store, the Target Corporation will provide the City of Morgan Hill with a facade easement on the existing Target space. The facade easement will make it easier for the City and its Redevelopment Agency to step in and clean up the site and lien the property for reimbursement, if needed. The easement language can establish the maintenance standards to be followed. For this property, the easement language should give the City the right to enter onto the property and perform any deferred maintenance thereon as may be necessary to keep the property in good condition and repair, if the Target Corporation or successor in ownership (the “owner”) does not perform such maintenance itself within a set period of time after receiving notice of the need for maintenance. Such notice shall identify each item of maintenance and repair required to restore the landscaping and exterior facade on the Property to good condition and repair. All costs of maintenance performed by the City of Morgan Hill shall be paid directly by the owner or be reimbursed to the City by the owner. The owner’s obligation to reimburse the City shall be secured by a lien encumbering the Property, which lien shall be enforceable in accordance with the provisions of California Civil Code Section 2924 et seq., as amended. This facade easement will be granted for a period not to exceed five years, or until a majority of the space is re-occupied for a period of at least 12 consecutive months.

3. *Commitment to Re-Tenancing of Vacant Target Store.* The Target Corporation shall provide the City with a written re-tenancing plan for the vacant store. Every six months until the majority of the space is leased to a tenant(s) with a lease commitment of at least 12 months, or sold to another independent party, the Target Corporation shall provide to the City of Morgan Hill a progress report on efforts to re-lease the vacant space. The Target Corporation shall not put restrictions on the types of retailers permitted, e.g., they will not refuse to lease to a Target competitor. Permitted activities and land uses shall be solely governed by the City’s General Plan and Zoning Ordinance

Level of Significance Remaining After Mitigation

Based on the analysis here, BAE believes that urban decay is not a likely outcome for centers and retail nodes other than Cochrane Plaza, especially if the citywide mitigations described above are implemented. However, in the case of Cochrane Plaza, these mitigations and those that are center-specific may be somewhat effective, but it cannot be stated with any degree of certainty that they would prevent urban decay in that center. Thus, it is possible that the construction of the Proposed Project might lead to a significant and unavoidable impact with respect to urban decay and physical deterioration for Cochrane Plaza.

Introduction

Background and Study Purpose

DiNapoli Browman Guglielmo Development has submitted a proposal to the City of Morgan Hill for a large new retail center. As part of its evaluation of the proposed project, the City of Morgan Hill has retained Pacific Municipal Consultants to complete an Environmental Impact Report (EIR). Recent California court decisions (*Bakersfield Citizens for Local Control v. City of Bakersfield*, *Panama 99 Properties LLC*, and *Castle & Cooke Commercial-CA, Inc.*, as well as *Dolan Ingram, et al. v. City of Redding and Wal-Mart, Inc, et al.*) have made clear that for large retail developments, an economic impact analysis should be undertaken to assess the possibility of “urban decay” and deterioration and indirect physical impacts on the environment. In the Bakersfield decision, the Appellate Court made clear that such an impact needed to be given “meaningful consideration.” Both cases indicate that to fully satisfy the requirements of an EIR, the economic analysis must start with the economic impacts, but also follow the causal chain to assess the likelihood of new retail space causing existing space to become vacant, and following that outcome, determine the potential for urban decay and physical deterioration of existing retail centers and nodes. The City of Morgan Hill has retained Bay Area Economics (BAE) to undertake an economic impact analysis as part of the EIR process for this project. BAE aims to use the best available information to assess the economic impacts and then establish whether these economic impacts might result in a negative effect on the physical environment of Morgan Hill as manifested by urban decay and physical deterioration of existing retail centers.

Project Description

The retail project (as yet unnamed, referred to in this report as the “Proposed Project”) is proposed as an approximately 650,000 square-foot retail center at the Cochrane Road exit from U.S. Highway 101, to the east of the highway and the north of Cochrane Road. The Proposed Project consists of a mix of retail space configurations in several large buildings and free-standing pads, including two anchor spaces of more than 100,000 square feet, a movie theater complex of 63,200 square feet, additional store spaces ranging from 4,000 to 30,000 square feet, and several pad spaces suitable primarily for fast-food restaurants. At this time, the committed tenant is Target, slated to be a major anchor in a 123,800 square-foot space. A large anchor space adjacent to Target is configured for a large home improvement store, but no retailer is committed to this space. The conceptual site plan for the Proposed Project indicates two alternative land uses for portions of the project, as follows: a 50,000 square-foot food store in place of two adjacent 20,000 and 30,000 square-foot retail spaces; and a fuel station in place of a 6,000 square-foot pad.

The developers have expressed an interest in developing this center as a “lifestyle center,” with an emphasis on higher-end stores, dining, and entertainment (as indicated by the movie theater complex), creating a destination shopping experience drawing from outside Morgan Hill. However, at the time of this analysis there are no committed tenants in these categories. For the purposes of this analysis, the Proposed Project is configured as shown in Table 1, which includes the Target, a home improvement center, the theater complex, a supermarket, a fuel station, restaurants, and unspecified retail.

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| Table 1: Proposed Project Property Information | | | |
|---|---------------|----------------|----------------------------|
| Location | Type | Square Feet | Tenant |
| Major 1 | Retail | 123,800 | Target |
| Major 2 | Retail | 18,600 | |
| Major 3 | Retail | 18,000 | |
| Major 4 | Retail | 20,000 | |
| Major 5 | Retail | 18,000 | |
| Major 6 | Retail | 20,000 | Food Store (Alternative) |
| Major 7 | Retail | 30,000 | Food Store (Alternative) |
| Major 8 | Retail | 140,000 | Home Improvement |
| Major 9 | Retail | 18,175 | |
| Major 10 | Retail | 16,000 | |
| Major 11 | Retail | 16,000 | |
| Major 12 | Retail | 18,175 | |
| Total Major Area | | 456,750 | |
| Shops A | Retail | 7,400 | |
| Shops B | Retail | 6,000 | |
| Shops C | Retail | 12,000 | |
| Shops D | Retail | 8,000 | |
| Shops E | Retail | 6,400 | |
| Shops F | Retail | 4,000 | |
| Shops G | Retail | 5,000 | |
| Shops H | Retail | 6,000 | |
| Shops I | Retail | 4,500 | |
| Shops J | Retail | 8,850 | |
| Shops K | Retail | 8,000 | |
| Shops L | Retail | 7,125 | |
| Shops M | Retail | 7,125 | |
| Total Shops Area | | 90,400 | |
| Pad 1 | Restaurant | 4,000 | Fast Food |
| Pad 2 | Restaurant | 6,000 | Fuel Station (Alternative) |
| Pad 3 | Restaurant | 3,500 | Fast Food |
| Pad 4 | Restaurant | 4,000 | Fast Food |
| Pad 5 | Restaurant | 3,500 | Fast Food |
| Pad 6 | Restaurant | 3,500 | Fast Food |
| Pad 7 | Restaurant | 4,500 | Fast Food |
| Pad 8 | Restaurant | 7,500 | Restaurant |
| Total Pad Area | | 36,500 | |
| Cinemas | Movie Theater | 63,200 | Movie Theater |
| Total Building Area | | 646,850 | |
| Garden Center | | 10,400 | With Major 8 |
| Total Center Store Area | | 657,250 | |
| All sizes are approximate. | | | |
| Sources: DiNapoli Browman Guglielmo Development; City of Morgan Hill; CA State Board of Equalization; Bay Area Economics. | | | |

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Approach. For purposes of this analysis it is assumed that the project will be fully developed and occupied within a few years. The purpose of this report is not to assess whether the retail market area can support this project, but to assess the impacts of the proposed project assuming that it is constructed as planned. The analysis assumes that this will be a fully functioning center, with all of the project's outlets achieving a level of revenue reflective of the national averages for each sector represented in the project. This is considered a reasonable and defensible basis upon which to evaluate the potential economic impacts of the proposed project. However, if this leads to the conclusion that the center will capture an unrealistic share of local sales in a given category, the analysis considers more likely outcomes, such as both the new outlet and the existing outlets performing below industry benchmarks.

Population and Employment Overview

Introduction

This section presents background information on current and projected demographic and economic conditions in Morgan Hill, a Target Trade Area, and a Cinema Trade Area. A trade area is the geographic region that encompasses most of a retail outlet's customers, or can be defined as including all the outlets that serve a particular market niche. These Trade Areas have been defined based on the geographic area likely to be the primary source of customers for the uses as discussed in the following Trade Area definitions. As explained below, the Target Trade Area encompasses all uses aside from the movie theaters. Developing an economic and demographic profile of these areas will provide background information that will assist in estimating future retail sales in the areas and in assessing the potential impacts of the Proposed Project on other retail outlets and centers. Data sources include the U.S. Census Bureau, including the 1990 and 2000 Census, the California Employment Development Department (EDD), the Association of Bay Area Governments (ABAG), and Claritas, a private vendor providing estimates of current and future demographic conditions.

Definition of the Target Trade Area

The Target Trade Area has been defined as the area from which the Target anchor tenant is likely to draw most of its customers. This area has been bounded based primarily on the location of other Target stores in nearby population centers, on the assumption that shoppers would tend to go to the Target closest to their residence (see Figure 1). The Target Area consists primarily of Morgan Hill and surrounding unincorporated areas, but also includes the Coyote Valley area of San Jose. This Trade Area is also used for most of the other center tenants. It was used for the home improvement land use and the restaurant uses since the area is similarly surrounded by other large home improvement centers and fast food restaurants in San Jose and Gilroy. For food stores, Morgan Hill and its immediate environs can be seen as one market, although the individual stores may have even smaller market areas. This Trade Area was also used for the undefined retail uses in the absence of detailed information on specific tenants whose market area might not be constrained by the significant region-serving retail concentrations in Gilroy and San Jose.

Definition of Cinema Trade Area

The Cinema Trade Area has been defined based on the area likely to provide most of the customers for a multiscreen theater complex as proposed. As shown in Figure 2, the Cinema Trade Area encompasses all of the Target Trade Area and extends south through Gilroy to the Santa Clara County borders with Santa Cruz and San Benito Counties. To the north, while a large new complex in a well-designed center would garner some movie-goers from San Jose, the major theater complexes in South San Jose will still capture most of the customer base due to their proximity. To the south, the presence of other screens in Hollister and Watsonville as well as sheer distance will preclude the capture of significant numbers of customers.

Both Trade Areas are defined using Census Block Groups, and a listing of the Block Groups can be found in Appendices A-1 and A-2.

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Figure 1: Target Market Area

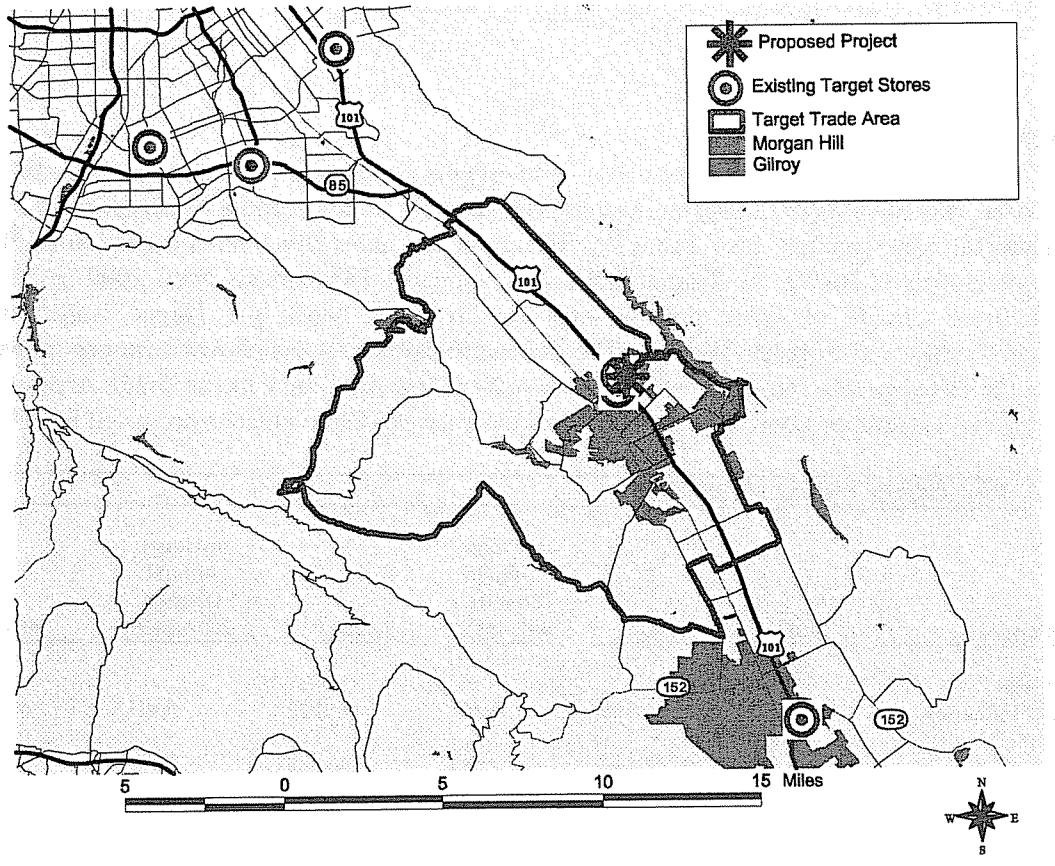
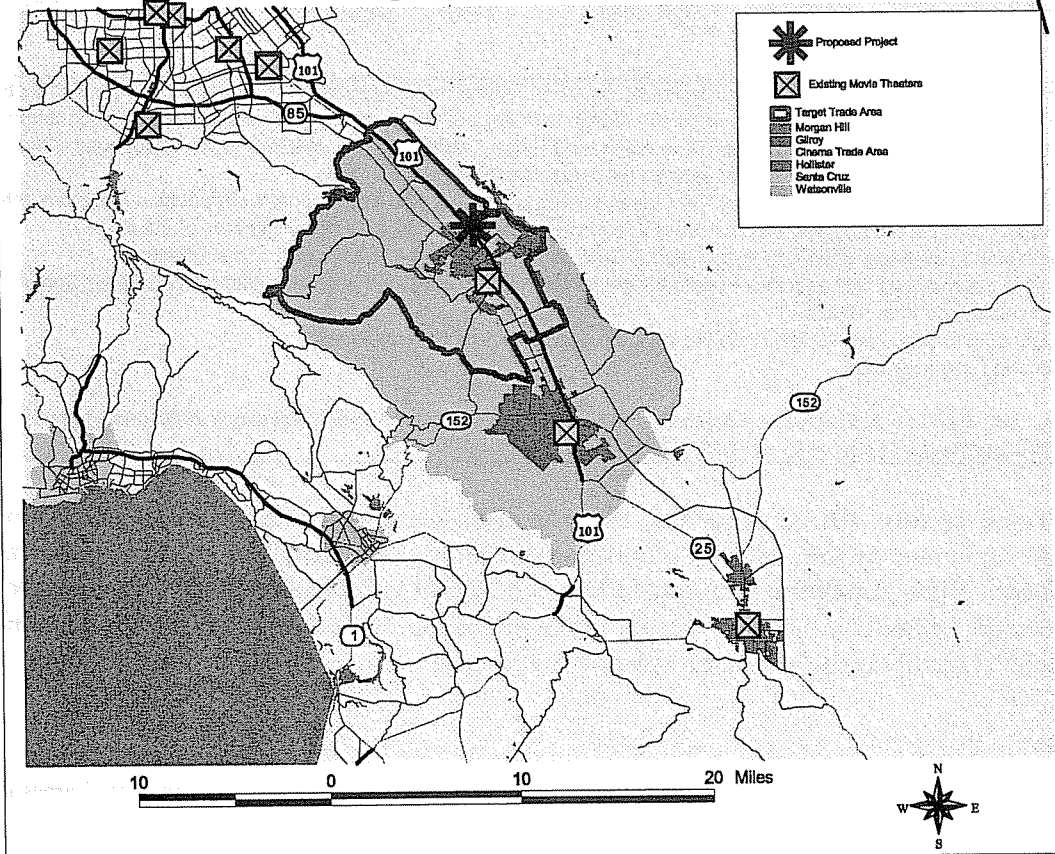


Figure 2: Cinema Trade Area



Population Trends

Short-Term Trends. The Target Trade Area is undergoing moderate population growth, keyed largely to the residential growth caps in place in Morgan Hill, which permits construction of only 250 residential units annually (see Table 2). Based on estimates from the Association of Bay Area Governments (ABAG), the Target Trade Area gained 2,844 persons from 2000 to 2005, with additional growth of 4,100 persons expected by 2010, when the Target Trade Area population is projected to reach 53,486. The Cinema Trade Area has shown stronger growth, based on the faster growth rate of Gilroy. Between 2000 and 2005 the Cinema Trade Area grew from 97,009 to 105,288 persons, with an additional increase of 10,600 persons projected by 2010.

Table 2: Population Trends, 1990-2010

| Population | 1990 | 2000 | Average Annual Change 1990-2000 | 2005 | Average Annual Change 2000-2005 | 2010 | Average Annual Change 2005-10 |
|---------------------------------|------------|------------|---------------------------------|------------|---------------------------------|------------|-------------------------------|
| Morgan Hill Sphere of Influence | 30,077 | 38,156 | 2.4% | 41,000 | 1.4% | 45,100 | 1.9% |
| Target Trade Area (a) | 36,957 | 46,542 | 2.3% | 49,386 | 1.2% | 53,486 | 1.6% |
| Cinema Trade Area (b) | 76,902 | 97,009 | 2.3% | 105,288 | 1.7% | 115,888 | 1.9% |
| Santa Clara County (c) | 1,497,577 | 1,682,585 | 1.2% | 1,750,100 | 0.8% | 1,855,500 | 1.2% |
| State of California (d) | 29,760,021 | 33,871,648 | 1.3% | 36,810,358 | 1.7% | 39,246,767 | 1.3% |

(a) Target Trade Area is 22 Census Block Groups as shown in Figure 1 and Appendix A-1. Population increase has been estimated by assuming all growth in Target Trade Area occurs in Morgan Hill Sphere of Influence, which includes the City of Morgan Hill and immediately surrounding areas. Population of remainder of Target Trade Area assumed to remain unchanged. This reflects a conservative approach as well as a lack of data for the remainder of the defined area.

(b) Cinema Trade Area is 45 Census Block Groups as shown in Figure 2 and Appendix A-2. Population has been estimated assuming all growth in the Lifestyle Trade Area is occurring in the Morgan Hill and Gilroy Spheres of Influence. Population in the remainder of the Lifestyle Trade Area is assumed to remain unchanged. This reflects a conservative approach as well as a lack of data for the remainder of the defined area. Morgan Hill and Gilroy Sphere of Influence population estimates from ABAG.

(c) 2005 and 2010 from ABAG. 2005 number is within one percent of DOF estimate.

(d) 2005 and 2010 from DOF.

Sources: 1990 & 2000 U.S. Census; Association of Bay Area Governments (ABAG) *Projections 2000* and *Projections 2005*; California State Department of Finance (DOF), 2005; BAE, 2005.

Long-Term Trends. ABAG projections estimate that Morgan Hill will continue to grow slowly with growth limited by the city's growth caps, while Gilroy will grow at a faster rate (see Table 3). Morgan Hill's population is projected to reach 50,000 in 2030 and Gilroy's is expected to reach 66,400.¹ Similar projections are not available for the Trade Areas, but most of the Trade Area populations are in the two cities' spheres of influence.

¹ Population projections for City Spheres of Influence, which include surrounding unincorporated areas that may ultimately become part of the cities.

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Table 3: Population Projections

| | 2000 | 2005 | 2010 | 2020 | 2030 | Annual % Change 2005-2030 |
|--|-----------|-----------|-----------|-----------|-----------|---------------------------------|
| Morgan Hill Sphere of Influence | 38,156 | 41,000 | 45,100 | 48,900 | 50,000 | 0.8% |
| Gilroy Sphere of Influence | 48,065 | 53,500 | 60,000 | 64,600 | 66,400 | 0.9% |
| Santa Clara County | 1,682,585 | 1,750,100 | 1,855,500 | 2,073,300 | 2,267,100 | 1.0% |

Source: Association of Bay Area Governments *Projections 2005*.

A key factor affecting long-term population growth potential in the Trade Area is the development of Coyote Valley in San Jose. The City of San Jose is currently developing a Specific Plan for this area, and is attempting to apply “Smart Growth” concepts to its development. One key element of the growth plan is to begin to develop an employment base prior to commencing residential construction. Current plans call for 50,000 “driving industry” jobs and 25,000 total residential units housing 80,000 people. Along with a stable fiscal condition for the City, job creation is the “trigger” for City adoption of the Specific Plan, which will then allow other uses to move forward.² As currently envisioned, Coyote Valley will not have any region-serving retail; if the final plans maintain this pattern, it could considerably benefit Morgan Hill in drawing customers seeking region-serving retail and trying to avoid congestion elsewhere in San Jose.

According to market analysis completed by EPS,³ total jobs will not reach 5,000 until 2012, at which point limited residential development can commence. Full buildout is not expected for 30 to 40 years. Given the requirements for substantial job creation prior to the initiation of residential development, the prospects for housing in the near term are limited. Santa Clara County is still in the midst of a substantial economic slowdown, with over 150,000 fewer employed residents in 2004 than in 2000 (see Appendix B). As a result of this slowdown, there is substantial vacant space available in the industrial market, with Silicon Valley showing a vacancy rate of 10.6 percent out of over 100 million square feet of space.⁴ Similar conditions prevail in the R&D and office real estate markets.⁵ Under these conditions, there is little incentive to build new space, since existing space is often available for less than the cost of construction.

² http://www.sanjoseca.gov/coyotevalley/docs/FAQ/FAQ_Sec7.pdf

³ *Draft Report, Market Analysis for Workspace Development in Coyote Valley*, Economic and Planning Systems, Inc., August 4, 2004.

⁴ CBRE, *Silicon Valley Industrial Market View*, First Quarter 2005

⁵ CBRE, *Silicon Valley R&D Market View*, First Quarter 2005, *Silicon Valley Office Market View*, First Quarter 2005

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There have been suggestions from San Jose's Mayor recently that residential development should be permitted prior to the job development. At this time, no approvals (including amending San Jose's General Plan) have been given for this approach, and it is likely to prove controversial if pursued. As a result, the analysis here assumes that the current planning process will move forward in the context of existing General Plan Guidelines. Any change in development timing or relaxing of the job creation "trigger" is speculative at this time – for instance, if residential development does not follow the current planning process, retail development may also follow, with creation of a region-serving center in Coyote Valley to serve its residents and others. This report assumes that substantial development in Coyote Valley will be a long-term prospect, and is unlikely to be a source of retail customers for Morgan Hill in the time frame of this analysis.

Household Trends

Household Growth. As shown in Table 4, the rates of household growth in the two Trade Areas mirror the respective population growth rates. The Target Trade Area contains an estimated 15,857 households as of 2005, with an additional 1,260 households expected by 2010. The Cinema Trade Area has an estimated 2005 population of 32,068, with an increase of 3,110 households by 2010.

Table 4: Household Trends, 1990-2010

| Households | 1990 | 2000 | Average Annual Change 1990-2000 | 2005 | Average Annual Change 2000-2005 | 2010 | Average Annual Change 2005-10 |
|---------------------------------|---------|---------|---------------------------------|---------|---------------------------------|---------|-------------------------------|
| Morgan Hill Sphere of Influence | 9,880 | 12,226 | 2.2% | 13,330 | 1.7% | 14,590 | 1.8% |
| Target Trade Area (a) | 11,694 | 14,753 | 2.4% | 15,857 | 1.5% | 17,117 | 1.5% |
| Cinema Trade Area (b) | 23,638 | 29,209 | 2.1% | 32,068 | 1.9% | 35,178 | 1.9% |
| Santa Clara County (c) | 520,180 | 565,863 | 0.8% | 595,550 | 1.0% | 628,670 | 1.1% |

(a) Target Trade Area is 22 Census Block Groups as shown in Figure 1 and Appendix A-1. Increase in households has been estimated by assuming all growth in Target Trade Area occurs in Morgan Hill Sphere of Influence, which includes the City of Morgan Hill and immediately surrounding areas. Number of households in remainder of Target Trade Area assumed to remain unchanged. This reflects a conservative approach as well as a lack of data for the remainder of the defined area.

(b) Cinema Trade Area is 45 Census Block Groups as shown in Figure 2 and Appendix A-2. Population has been estimated assuming all growth in the Lifestyle Trade Area is occurring in the Morgan Hill and Gilroy Spheres of Influence. Population in the remainder of the Lifestyle Trade Area is assumed to remain unchanged. This reflects a conservative approach as well as a lack of data for the remainder of the defined area. Morgan Hill and Gilroy Sphere of Influence population estimates from ABAG.

(c) 2005 and 2010 from ABAG. 2005 number is within one percent of DOF estimate.

Sources: 1990 & 2000 U.S. Census; Association of Bay Area Governments (ABAG) *Projections 2000* and *Projections 2005*; California State Department of Finance (DOF), 2005; BAE, 2005.

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Tenure. Owner and renter households have differing purchasing patterns, and this can be reflected by the retail mix found in an area. The Target Trade Area has over 70 percent of households in owner units, and the Cinema Trade Area has over 65 percent in owner units, in contrast to less than 60 percent in Santa Clara County and statewide (see Table 5). The Target Trade Area and Santa Clara County showed little change in these proportions during the 1990s, while the Cinema Trade Area showed a slight increase, likely due to the construction of new homes in Gilroy. Typically, owners have higher incomes, have larger households, and tend to spend more on home repair and home furnishings and other durable goods and less on dining out.

| Table 5: Tenure of Households | | |
|--|-------|-------|
| | 1990 | 2000 |
| City of Morgan Hill | | |
| Owner | 71.5% | 72.5% |
| Renter | 28.5% | 27.5% |
| Target Trade Area | | |
| Owner | 72.1% | 73.0% |
| Renter | 27.9% | 27.0% |
| Cinema Trade Area | | |
| Owner | 65.5% | 68.2% |
| Renter | 34.5% | 31.8% |
| Santa Clara County | | |
| Owner | 59.1% | 59.8% |
| Renter | 40.9% | 40.2% |
| California | | |
| Owner | 55.6% | 56.9% |
| Renter | 44.4% | 43.1% |
| Sources: 1990 & 2000 U.S. Census; BAE, 2005. | | |

Household Income. Household incomes and resulting consumer buying power are key factors in assessing the potential for additional retail development. Relative to Santa Clara County with a median household income of \$85,096, the Target Trade Area shows relatively high incomes, with a 2004 median household income estimated at \$95,417 (see Table 6). Nearly half of Target Trade Area households had incomes of \$100,000 or more. The Cinema Trade Area shows a median annual household income similar to the county's, at \$83,688, and has 40 percent of households with annual incomes of \$100,000 or more. All of these geographies reflect a strong income base, as the statewide median household income for 2004 is estimated at only \$52,349. The higher incomes in the Trade Areas may be manifested in higher retail expenditures and a preference among many households for upscale shopping.

| Table 6: Estimated 2004 Household Income Distribution | | | | |
|--|-----------------|-------------------|-------------------|--------------------|
| 2004 Income | Morgan Hill | Target Trade Area | Cinema Trade Area | Santa Clara County |
| Less than \$15,000 | 5.6% | 5.3% | 6.2% | 6.7% |
| \$15,000 - \$24,999 | 4.4% | 4.1% | 5.0% | 5.1% |
| \$25,000 - \$34,999 | 5.8% | 6.2% | 7.0% | 6.1% |
| \$35,000 - \$49,999 | 8.4% | 8.3% | 10.1% | 9.5% |
| \$50,000 - \$74,999 | 13.0% | 14.1% | 16.4% | 16.5% |
| \$75,000 - \$99,999 | 15.1% | 14.7% | 15.3% | 15.0% |
| \$100,000 - \$149,999 | 20.4% | 19.9% | 19.4% | 18.9% |
| \$150,000 or more | 27.3% | 27.4% | 20.6% | 22.1% |
| Total | 100% | 100% | 100% | 100% |
| Median Income | \$96,225 | \$95,417 | \$83,688 | \$85,096 |
| Sources: Claritas, Inc., 2004; Bay Area Economics, 2005. | | | | |

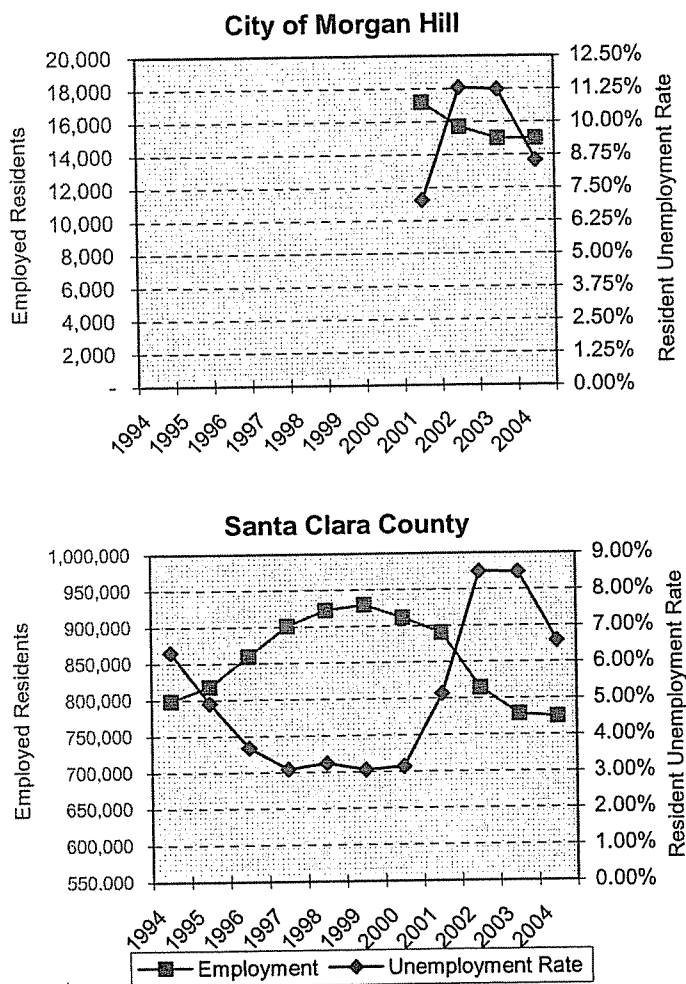
Labor Force Trends

Employed Residents and Unemployment. Employment can be an indicator of regional buying power; unemployed workers and their households will have reduced incomes and lower expenditures. Growth in the employed labor force of an area can indicate increased buying

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power. Santa Clara County has undergone a serious decline since the height of the “dot-com” bubble in 1999 and 2000. As shown in Figure 3 and Appendix B, unemployment climbed from 3.1 percent to 8.5 percent in 2002 and 2004, with a recent decline to 6.6 percent. The number of employed residents has declined every year from a peak of 929,300 in 1999 to 774,800 in 2004. This is a smaller number of employed workers than in 1993. Morgan Hill has followed countywide trends, with a higher proportion of unemployed. Annual average unemployment in 2004 in Morgan Hill is estimated at 8.5 percent, with 15,000 employed residents. These economic trends have had a significant impact on sales in the city and county, as discussed below.

Figure 3: Employed Residents and Unemployment Rate



Data presented are for residents of the area by place of residence, not workers by place of work. Annual data are annual averages. For detailed data, see Appendix B.

Sources: California Employment Development Department; Bay Area Economics, 2005.

Morgan Hill Commuter Flows. In addition to local residents, workers in an area can generate retail sales as they spend money near their place of work, particularly on meals eaten during the

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work day. Based on 2000 Census commuter data,⁶ Morgan Hill has approximately 16,000 employed residents, and slightly less than 13,000 persons employed in the city (see Table 7). However, there are considerable flows in both directions, with 76.5 percent of the employed residents working outside the city (mostly elsewhere in Santa Clara County, especially San Jose).

Table 7: Morgan Hill Commuter Flows, 2000

| Morgan Hill Residents by Place of Work | | |
|--|---------------|----------------|
| Place of Work (a) | Number | Percent |
| Santa Clara County | 14,635 | 92.0% |
| San Jose | 5,290 | 33.2% |
| Morgan Hill | 3,740 | 23.5% |
| Santa Clara | 1,155 | 7.3% |
| Gilroy | 825 | 5.2% |
| Sunnyvale | 765 | 4.8% |
| Palo Alto | 385 | 2.4% |
| Mountain View | 345 | 2.2% |
| Cupertino | 330 | 2.1% |
| Milpitas | 325 | 2.0% |
| Campbell | 250 | 1.6% |
| Other Cities | 475 | 3.0% |
| Unincorporated | 750 | 4.7% |
| Alameda County | 312 | 2.0% |
| San Mateo County | 303 | 1.9% |
| Elsewhere in California | 661 | 4.2% |
| GRAND TOTAL | 15,911 | 100.0% |
| Residents Commuting out of Morgan Hill | 12,171 | 76.5% |
| Morgan Hill Workers by Place of Residence | | |
| Place of Residence (b) | Number | Percent |
| Santa Clara County | 10,863 | 84.4% |
| Morgan Hill | 3,740 | 29.0% |
| San Jose | 2,875 | 22.3% |
| Gilroy | 1,740 | 13.5% |
| Other Cities | 839 | 6.5% |
| Unincorporated | 1,669 | 13.0% |
| San Benito County | 675 | 5.2% |
| Hollister | 420 | 3.3% |
| Remainder, San Benito County | 255 | 2.0% |
| Monterey County | 329 | 2.6% |
| Alameda County | 282 | 2.2% |
| Santa Cruz County | 276 | 2.1% |
| Elsewhere in California | 450 | 3.5% |
| GRAND TOTAL | 12,875 | 100.0% |
| Workers Commuting into Morgan Hill | 9,135 | 71.0% |
| (a) All places showing 250 or more workers commuting from Morgan Hill are shown. | | |
| (b) All places showing more than 250 workers commuting into Morgan Hill are shown. | | |
| Tables exclude a small number of residents who commute out of state, and a small number of workers who commute in from out of state. | | |
| Source: 2000 Census Transportation Planning Package. | | |

Of those working in Morgan Hill, 71.0 percent come from outside the city, with approximately 36 percent of all workers coming from San Jose or Gilroy. There are many persons working in Morgan Hill who are not residents, representing a potential source of additional retail expenditures in the city, but there are more residents commuting outside the city, and they will also be likely to frequent restaurants and shops near their place of work. Effectively, the two groups may cancel each other out as far as retail expenditures, with no net gain in sales in Morgan Hill. However, the presence of additional retail options might lead to additional expenditures near the place of work in Morgan Hill. *Office Worker Retail Spending Patterns*, published in 2004 by the International Council of Shopping Centers, addresses this question to some extent. While comparative data for suburban workers are not available, data for downtown workers with and without ample retail nearby indicate that workers with ample retail near the place of work spend

⁶ 2000 Census Transportation Planning Package. It should be noted that given current economic conditions, the number of workers living in Morgan Hill or working in Morgan Hill may be lower than in 2000.

\$231 more annually near their place of work than those without ample retail. Given the number of workers commuting into Morgan Hill, this translates into roughly \$2.1 million in additional capturable retail sales, or only approximately 8,440 square feet of retail space at \$250 per square foot in annual sales.⁷ While these numbers are good guesses at best, they are evidence that the impact of worker expenditures given additional retail opportunities are likely to be of a very small order of magnitude.

Summary of Demographic and Economic Overview

The Target Trade Area is undergoing moderate population and household growth, keyed largely to the residential growth caps in place in Morgan Hill. It is estimated the Target Trade Area will have a population of 53,486 and 17,117 households by 2010. The Cinema Trade Area has shown stronger growth, based on the faster growth rate of Gilroy. The Cinema Trade area is expected to reach an estimated 115,888 persons and 35,178 households by 2010. Long term, these trends are expected to continue, with Gilroy's growth outpacing Morgan Hill's.

A key factor affecting long-term population growth potential in the Trade Area is the development of Coyote Valley in San Jose. Current plans call for 50,000 "driving industry" jobs and 25,000 total residential units housing 80,000 people. Along with a stable fiscal condition for the City, job creation is the "trigger" for City adoption of the Specific Plan, which will then allow other uses to move forward. As currently envisioned, Coyote Valley will not have any region-serving retail; if the final plans maintain this pattern, it could considerably benefit Morgan Hill in drawing customers seeking region-serving retail and trying to avoid congestion elsewhere in San Jose. However, in the current slow job market in San Jose, that city's market analysis indicates that total jobs will not reach 5,000 until 2012, at which point limited residential development can commence. Full buildout is not expected for 30 to 40 years. Recently San Jose's Mayor has suggested that residential development should be permitted first. At this time, no approvals (including amending San Jose's General Plan) have been given for this approach, so the analysis here assumes that the current planning process will move forward. Any change in development timing or relaxing of the job creation "trigger" is speculative at this time. This report assumes that substantial development in Coyote Valley will be a long-term prospect, and is unlikely to be a source of retail customers for Morgan Hill in the time frame of this analysis.

The Target Trade Area and to a lesser extent the Cinema Trade Area exhibit strong demographics for retail trade, with high home ownership and high household incomes in comparison to the state. However, the regional economy has been in a sustained downturn following the collapse of the high-tech economy, with a decline in employed residents in Santa Clara County in every year since 1999. This has been reflected in declines in retail sales in the county.

⁷ This analysis is about the increment in retail sales that might be generated by the additional retail provided by the Proposed Project; this should not be mistaken for total worker expenditures which is a much higher number. The workers commuting from outside Morgan Hill are already making retail purchases in the city; these cannot be attributed to the Proposed Project. It will generate only the difference due to new retail offerings.

Commuter flows indicate that Morgan Hill has more employed residents than jobs. Nearly three-fourths of the city's workers commute in from elsewhere, but the potential for additional dollars to be captured with an increase in retail is extremely limited.

Because of the demographic profile for the Trade Areas, Morgan Hill is well-suited for family-oriented retail geared toward households with moderate to high incomes. Target is geared toward this market, and lifestyle retail may also be well-suited, if the population base is sufficient to support it.

Retail Sales Analysis

This section examines retail trends in Morgan Hill, Gilroy, and Santa Clara County. The analysis covers the major uses considered for the Proposed Project. While the specific retailers for much of the center are undetermined, other categories of retail use that might locate in the Proposed Project are discussed. Overall retail sales trends in Morgan Hill and Gilroy are examined, as are trends for general merchandise stores, food stores, restaurants, and building materials stores. Movie theaters are discussed in more general terms due to the limited local data available. Summing up this analysis is a leakage and supportable square footage analysis for the Target Trade Area, focusing on the store categories above and on other store types that might locate in the Proposed Project. Finally, Lifestyle Retail Centers are discussed separately.

Overall Retail Sales

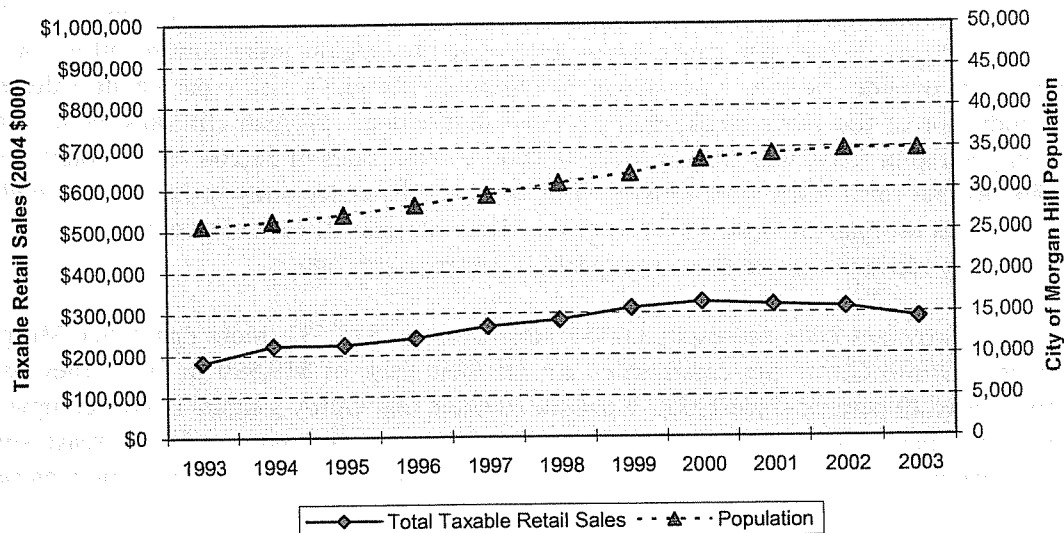
As shown in Figure 4, Morgan Hill's taxable retail sales⁸ have grown at a higher rate than the city's modest population growth, but total taxable retail sales have been declining on an inflation-adjusted basis since 2000. Taxable retail sales in 1993 were approximately \$192 million (in 2004 dollars), and grew to approximately \$326 million in 2000. Sales declined to \$287 million in 2003, for a net increase of 58 percent over the 1993 to 2003 study period. This increase was greater than population growth, which was 35 percent during the same period.

In contrast, Gilroy had a similar percentage increase in population (albeit from a larger base), but taxable retail sales climbed 90 percent from \$437 million in 1993 to \$832 million in 2003 (see Figure 5). Gilroy's 2003 sales were only slightly below their peak in 2001. Trends in Gilroy reflect its emergence as a region-serving retail center, including the opening of Costco in early 2003, the Gilroy Crossing center with Target, Mervyn's, and other region-serving big-box retail in 2004, and the upcoming Wal-Mart Supercenter later this year. Some of this increase may represent sales captured from Morgan Hill. For instance, general merchandise store sales in Morgan Hill dropped approximately \$12 million (or 16 percent) between 2002 and 2003, following the opening of Costco, and dropped another \$11 million (or 18 percent) between 2003 and 2004.

⁸ In California, the State Board of Equalization provides retail sales data by store type for most counties and for larger cities. This is the most up-to-date and reliable source available, but it only includes taxable sales. Most food items, prescription drugs, and certain other items are exempt from sales tax, so the reported taxable sales data excludes these non-taxable sales. Later in this section of the report, taxable sales as a proportion of total sales in supermarkets will be assessed.

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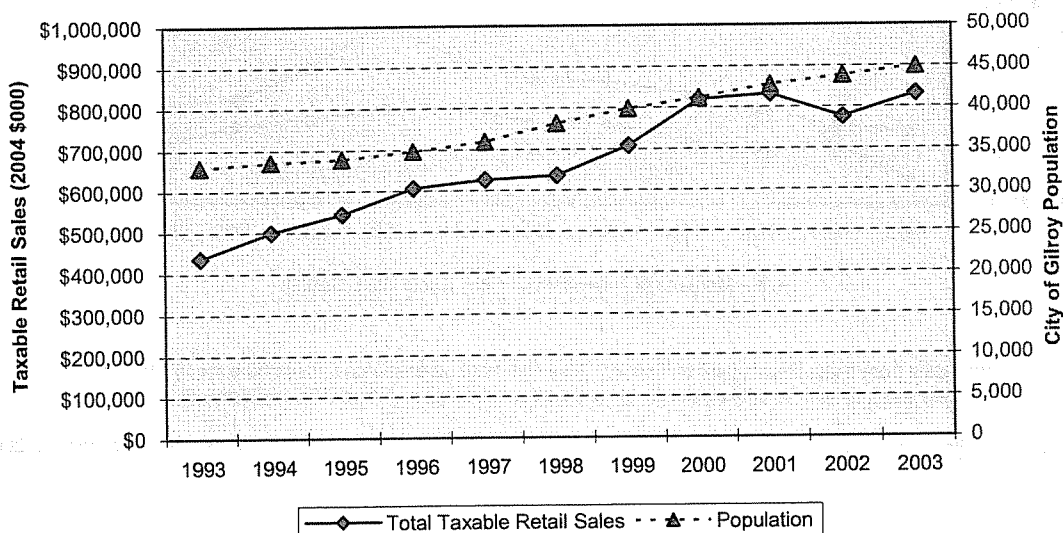
Figure 4: Morgan Hill Taxable Retail Sales and Population, 1993-2003



Notes: Population data from State Department of Finance. May vary from other sources. Sales here are taxable sales only, and exclude most food sales as well as prescription drugs and certain other items. Sales are presented in 2004 dollars. For details, see Appendix C.

Sources: State Board of Equalization; U.S. Bureau of Labor Statistics; State Department of Finance; Bay Area Economics, 2005.

Figure 5: Gilroy Taxable Retail Sales and Population, 1993-2003



Notes: Population data from State Department of Finance. May vary from other sources. Sales here are taxable sales only, and exclude most food sales as well as prescription drugs and certain other items. Sales are presented in 2004 dollars. For details, see Appendix C.

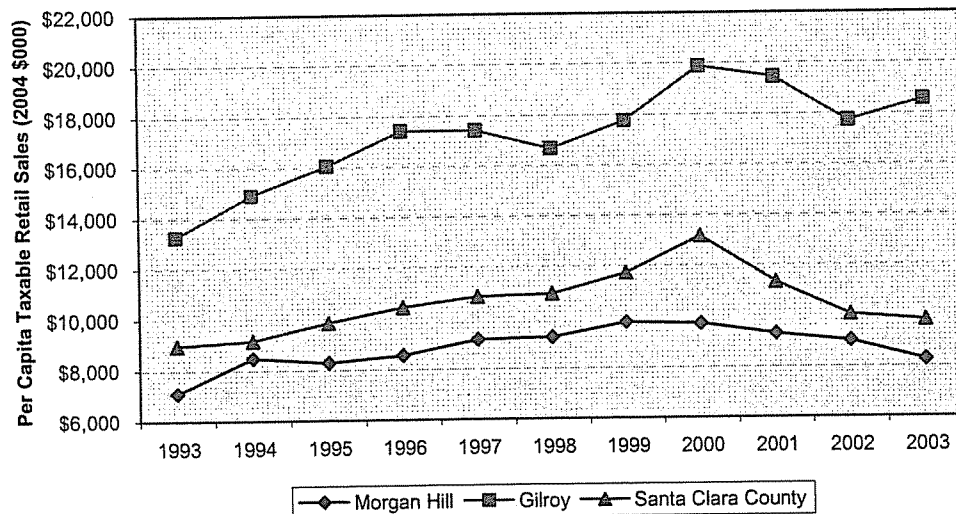
Sources: State Board of Equalization; U.S. Bureau of Labor Statistics; State Department of Finance; Bay Area Economics, 2005.

Per Capita Taxable Retail Sales

Per capita retail sales are an indicator of the relative strength of a city as a retail destination; other factors being equal, higher per capita sales relative to the region point toward attraction of shoppers from outside the city. As shown in Figure 6, Morgan's Hill's per capita sales are another indicator of the city's weakness as a retail destination. Morgan Hill lags Santa Clara County in per capita sales, with 2003 per capita taxable retail sales of \$8,260, while countywide per capita taxable retail sales were \$9,816. This is especially noteworthy in light of the higher income levels in Morgan Hill (see Table 6 above). Both Morgan Hill and the county have seen a significant drop-off in per capita sales from peaks of several years ago.

In contrast, Gilroy had 2003 per capita taxable retail sales of \$18,531, more than twice Morgan Hill's level. While Gilroy per capita sales are off their peak of \$19,890 in 2000, they have increased nearly 40 percent since 1993. It should be noted that Gilroy's figure is skewed upward by sales at the factory outlet mall, especially in apparel stores, but much of the increase since 1993 has been in other categories, particularly general merchandise stores and building materials stores.

Figure 6: Comparative Analysis, Per Capita Taxable Retail Sales



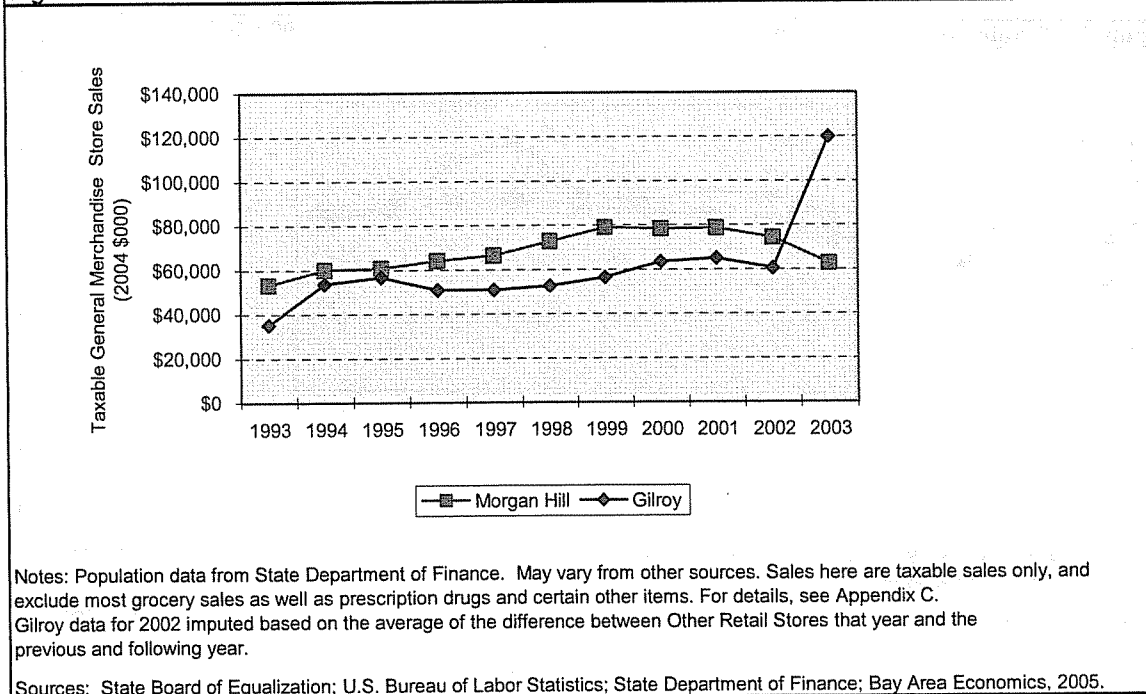
Notes: Population data from State Department of Finance. May vary from other sources. Sales here are taxable sales only, and exclude most grocery sales as well as prescription drugs and certain other items. For details, see Appendices C, D, & E.

Sources: State Board of Equalization; U.S. Bureau of Labor Statistics; State Department of Finance; Bay Area Economics, 2005.

General Merchandise Store Sales

As shown in Figure 7, general merchandise taxable sales in Morgan Hill increased through the 1990s, but declined between 2001 and 2003, with a significant decline of \$12 million (or 16 percent) between 2002 and 2003, to approximately \$63 million. As noted above, this loss may be due to the opening of Costco in Gilroy in early 2003. This is further indicated by the steep rise in general merchandise sales in Gilroy in 2003, as shown also in Figure 7. In fact, in 2003 general merchandise store sales in Gilroy surpassed Morgan Hill for the first time since at least 1993.

Figure 7: Taxable Sales Trends for General Merchandise Stores in Morgan Hill and Gilroy, 1993-2003



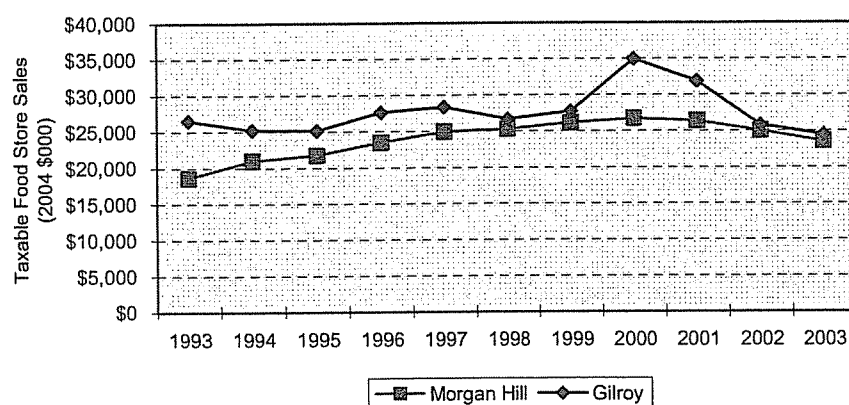
Food Store Sales

Historically, food store sales tended to be locally driven, with stores often located in a neighborhood-serving retail center and serving a trade area limited largely by proximity to consumers seeking everyday convenience purchases.⁹ This has changed as supermarkets have become larger, and as more specialized stores such as warehouse-format stores have developed. Stores such as Costco, Wal-Mart, and WinCo tend to encourage more pantry-loading, with customers coming from a larger trade area. In fact, the rise of stores such as Costco and major discount general merchandise stores are probably shifting sales away from conventional food stores entirely. Further changing the food store retailing environment is the rise of specialty supermarkets such as Whole Foods and Trader Joe's, which cater to an upscale clientele from a larger region.

⁹ According to the Urban Land Institute's *Shopping Center Development Handbook*, a neighborhood shopping center is usually anchored by a supermarket, requires three to 10 acres of land, and has gross leasable area of 30,000 to 100,000 square feet. Such centers typically serve a trade area population of 3,000 to 40,000 people.

Taxable Food Store Sales. As shown in Figure 8, taxable food store sales in Morgan Hill rose from \$18.6 million annually in 1993 to a peak of \$26.7 million in 2000, and since then have declined slightly to \$23.5 million. Gilroy's sales have been more volatile; taxable food store sales were \$26,528 in 1993, rose to \$35.0 million in 2000, and have since declined to \$24.5 million. This change is likely related to Gilroy's transition to a region-serving center. Grocery stores may see additional decline after 2003 due to Costco and the Wal-Mart Supercenter slated to open later this year.

Figure 8: Taxable Sales Trends for Food Stores in Morgan Hill and Gilroy, 1993-2003



Notes: Population data from State Department of Finance. May vary from other sources. Sales here are taxable sales only, and exclude most grocery sales as well as prescription drugs and certain other items. For details, see Appendices C & D.

Sources: State Board of Equalization; U.S. Bureau of Labor Statistics; State Department of Finance; Bay Area Economics, 2005.

Taxable vs. Non-Taxable Sales in Food Stores. One difficulty in quantifying food store sales is that in California, the annual data are only available for taxable items, and food items are for the most part non-taxable. To analyze total sales and assess impacts of a new project on existing supermarkets, it is necessary to estimate the percentage of a supermarket's sales that are non-taxable. One way to do this is to compare the taxable sales data with data from the Economic Census, which covers nontaxable sales as well as taxable sales; the most current Economic Census data are from 2002. Also useful in estimating total sales are stores that self-report, sales estimates from other independent sources such as Dun & Bradstreet, documented experience in other locales, and site visits to obtain a sense of the level of shopping activity. In making estimates of supermarket sales in an area, it is best to "triangulate" based on as many sources as possible.

A comparison of taxable sales data and Economic Census data (see Table 8) indicates that in Morgan Hill in 1997, an estimated 31 percent of food store sales were taxable, the same proportion as for California in 2002¹⁰. Santa Clara County in 2002 shows 25 percent of food store

¹⁰ It should be noted that this is a comparison of two data sources that rely on different collection methods, and that may not define food stores as precisely the same universe. Hence, the proportions should be seen

sales as being taxable. It should be noted that leakage analysis is very sensitive to changes in this assumption.

Table 8: Comparison of Total and Taxable Food Store Sales

| | <u>Morgan Hill (d)</u> | <u>Santa Clara County</u> | <u>State</u> |
|---|----------------------------|-------------------------------|--------------|
| Total Sales, from Economic Census (a) (b): | | | |
| Food and beverage stores | \$70,618 | \$3,270,229 | \$60,243,253 |
| Taxable Sales, from State Board of Equalization (c): | | | |
| Food Store Taxable Sales | \$21,550 | \$833,852 | \$18,951,412 |
| Percent Taxable Sales: | 31% | 25% | 31% |

Notes:

(a) Sales in \$1,000s.

(b) Sales expressed in uninflated dollars.

(c) These are the best matches available for type of store. Because they are not necessarily exact matches, and because the Economic Census and the State Board of Equalization rely on different data gathering methodologies, the percentages calculated here should be seen as general guides rather than hard and fast rules for food stores. Individual stores may vary widely due to product mix and other factors.

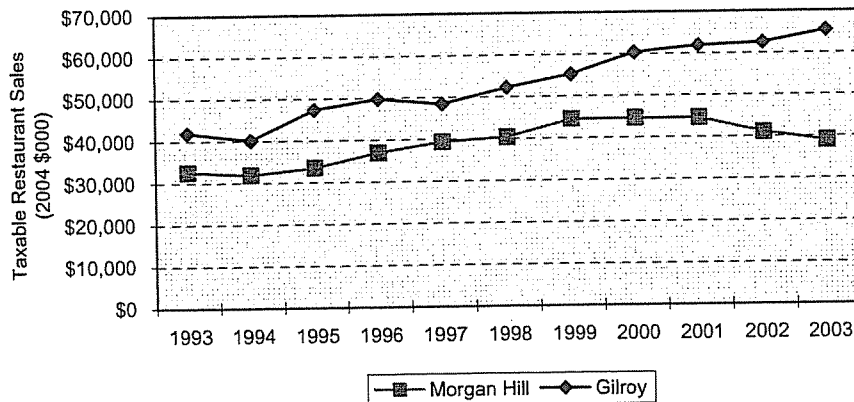
(d) Morgan Hill data from 1997; data for food and beverage store category not disclosed in 2002.

Sources: 1997 and 2002 Economic Census; California State Board of Equalization; Bay Area Economics, 2005.

Restaurant Sales

Another retail use indicated by the project site plan is restaurants, with some pads oriented toward fast food and others spaces available for sit-down dining. Taxable Sales at Eating and Drinking Places in Morgan Hill mirror food store taxable sales as far as change; in 1993, taxable sales in this category were \$32.6 million (see Figure 9). Sales peaked at \$44,661 in 2001, and declined to \$39,010 in 2003. In contrast, Gilroy sales have shown considerable growth with no significant annual declines, rising from \$41,931 to \$65,408 in 2003.

as generally informative and not as exact proportions. Also, the Morgan Hill data are from 1997 since the 2002 data were suppressed due to disclosure rules. It is possible that the proportions have changed since 1997.

Figure 9: Taxable Sales Trends for Eating & Drinking Places in Morgan Hill and Gilroy, 1993-2003

Notes: Population data from State Department of Finance. May vary from other sources. Sales here are taxable sales only, and exclude most grocery sales as well as prescription drugs and certain other items. For details, see Appendix C & D.

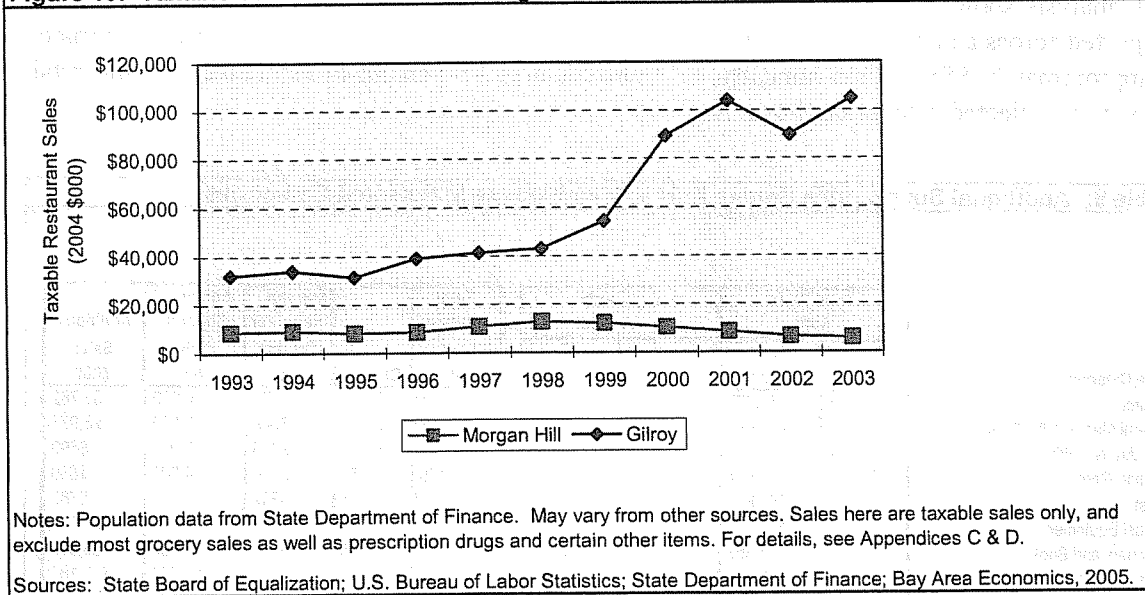
Sources: State Board of Equalization; U.S. Bureau of Labor Statistics; State Department of Finance; Bay Area Economics, 2005.

Analysis of more detailed data for subcategories indicates that Morgan Hill's restaurant sales are disproportionately in eating and drinking places not serving alcohol relative to Santa Clara County. Only 11 percent of the city's restaurants serve all kinds of alcohol, compared with 29 percent countywide. This may indicate a potential underserved market niche. On a per capita basis, Morgan Hill is only slightly below the county, with 2003 restaurant sales of \$1,123 compared to \$1,272 countywide. Some of these differences from the county may be a reflection of the more family-oriented nature of Morgan Hill, with less singles and childless couples frequenting sit-down restaurants and bars.

Building Materials Stores

Figure 10 shows trends in sales for building materials stores¹¹ in Morgan Hill and Gilroy. This sector has had very poor sales in Morgan Hill relative to Gilroy, and the gap widened considerably between 1993 and 2003. In 1993, Morgan Hill and Gilroy had sales in this category of \$8.6 million and \$32.0 million, respectively; in 2003, Morgan Hill's sales had declined to \$5.8 million, while Gilroy's had increased to \$104,927. This increase in Gilroy is linked to the opening of a Home Depot and Lowe's home improvement stores. More recently, Home Depot has opened a store in Morgan Hill, and unpublished taxable sales data indicates a major improvement in sales in this category as a result.

¹¹ This total includes stores in the following subcategories: Lumber and Building Materials; Hardware Stores; Plumbing and Electrical; Paint, Glass, and Wallpaper; and Farm Implements. It should be noted that this does not include wholesale lumber yards, which is the classification for Hale Lumber Co. and Johnson Lumber Co., even though those outlets also have retail sales.

Figure 10: Taxable Sales Trends for Building Materials Stores in Morgan Hill and Gilroy, 1993-2003

Movie Theaters

The Proposed Project includes a 63,200 square-foot space for a movie theater complex. As proposed, this would consist of a “megaplex” of 14 screens. In Morgan Hill, there is one operating movie theater complex, a “multiplex” of eight screens in the Tennant Station shopping center. Following a period of bankruptcy and consolidation in the industry, the number of screens nationally has stabilized in recent years, indicating a reasonably good fit between supply and demand at this time. While business level data for the Morgan Hill multiplex are not available, based on national sales data¹² and number of screens, the current eight screens would generate \$2.5 million annually if performing at average national levels.

Demand for New Retail Space in the Target Trade Area

Demand from Existing Population. Using 2004 taxable sales data with a finer-grained set of retail categories,¹³ BAE has estimated the additional amount of retail space that could be supported by the current population in the Target Trade Area. The results of this analysis are shown in aggregated form in Table 9. The analysis, shown in more detail in Appendix G, has delineated categories where there is estimated “leakage”¹⁴ of retail sales out of the trade area, applied a capture rate to that leakage, and estimated the supportable square footage in that category based on typical store performance in that category. The notes in Table 9 provide a more complete discussion of the methodology used. The analysis has been limited to retail sales types that could be located in the Proposed Project; for example, auto dealers have been excluded from the analysis. However, the analysis has not been limited to “lifestyle retail” store types.

¹² 2002 Economic Census for the Information sector.

¹³ From City of Morgan Hill.

¹⁴ Retail sales are said to be “leaking” from an area sales data indicate that residents are spending their money outside the trade area. If the data indicate sales above what would be expected from residents, the area is said to have sales “injections.”

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This analysis shows a total of 271,000 additional square feet of retail store space that could be supported across a number of categories. The total additional sales dollars capturable is estimated at approximately \$88 million annually, or approximately 36 percent of estimated existing retail sales in the selected categories shown in Table 9.

Table 9: Additional Supportable Square Feet of Retail Space in Selected Categories

| Store Category | Total Sales \$000 | | Per Capita Retail Sales | | Total Injection/ (Leakage) \$000 | Capture | Average Sales per Square Foot | Additional Support- able SF | Additional Sales \$000 |
|---------------------------------|----------------------|--------------|----------------------------|--------------|---|---------|--|--------------------------------------|------------------------------|
| | Morgan Hill | SC County | Morgan Hill | SC County | | | | | |
| Apparel | \$11,658 | \$953,908 | \$242 | \$554 | (\$15,046) | 25.0% | \$376 | 10,000 | \$3,762 |
| General Merchandise/Drug | \$51,294 | \$2,828,499 | \$1,064 | \$1,642 | (\$27,888) | 25.0% | \$249 | 28,000 | \$6,975 |
| Gifts, Art, Novelties | \$1,164 | \$91,507 | \$24 | \$53 | (\$1,397) | 49.4% | \$345 | 2,000 | \$690 |
| Sporting Goods | \$4,993 | \$220,424 | \$104 | \$128 | (\$1,178) | 74.7% | \$220 | 4,000 | \$880 |
| Florists | \$562 | \$50,886 | \$12 | \$30 | (\$863) | 91.2% | \$262 | 3,000 | \$787 |
| Musical Equipment | \$269 | \$103,047 | \$6 | \$60 | (\$2,616) | 74.7% | \$244 | 8,000 | \$1,954 |
| Stationery and Books | \$832 | \$215,358 | \$17 | \$125 | (\$5,197) | 75.1% | \$279 | 14,000 | \$3,905 |
| Office, Store and School Supply | \$3,053 | \$1,193,856 | \$63 | \$693 | (\$30,368) | 50.0% | \$276 | 55,000 | \$15,180 |
| Food Stores | \$82,673 | \$3,365,835 | \$1,714 | \$1,954 | (\$11,552) | 50.0% | \$385 | 15,000 | \$5,772 |
| Supermarkets | \$75,000 | | \$1,537 | | (\$10,480) | 50.0% | \$374 | 14,000 | \$5,240 |
| Eating & Drinking Places | \$42,101 | \$2,195,508 | \$873 | \$1,274 | (\$19,361) | 76.0% | \$525 | 28,000 | \$14,706 |
| Home Furnishings and Appliances | \$7,723 | \$819,613 | \$160 | \$476 | (\$15,222) | 75.1% | \$423 | 27,000 | \$11,430 |
| Building Materials | \$24,983 | \$1,349,205 | \$518 | \$783 | (\$12,787) | 90.0% | \$256 | 45,000 | \$11,510 |
| Other Retail | \$12,387 | \$1,109,903 | \$257 | \$644 | (\$18,684) | 56.3% | \$329 | 32,000 | \$10,513 |
| Total | \$243,692 | | | | (\$162,159) | | | 271,000 | \$88,064 |

Notes:

Data on supportable square footage by more detailed categories can be found in Appendix G. Additional supportable square feet here rounded to nearest thousand.

Per capita sales calculated based on reported taxable sales and population estimates and projections for the Target Trade Area from Table 2, prorated to 2003 as follows:

| | 2000 | 2003 | 2005 | Annual Change |
|-------------------|-----------|-----------|-----------|------------------|
| Target Trade Area | 46,542 | 48,228 | 49,386 | 1.2% |
| County | 1,682,585 | 1,722,775 | 1,750,100 | 0.8% |

County per capitulas sales have been assumed as baseline against which to compare Morgan Hill. Sales assumed to be "leaking" from Morgan Hill if Morgan Hill has per capita sales below county benchmark. While Morgan Hill's higher income levels may support additional retail, the relationship between total household income and purchases of certain goods in certain stores is not linear, and previous analysis by BAE indicates a complex relationship between many household characteristics and expenditures, with income being only one of the variables, along with household size, age, number of children, house cost, and other factors that can affect the availability of actual disposable income and what expenditures are made. Thus, to be conservative, BAE has used the broader county area, which is likely has limited leakage and still has a higher income than statewide, as a benchmark to estimate leakage. Assumptions have been made regarding possible capture by Morgan Hill of leakage in each category; for instance, Morgan Hill is unlikely to achieve high capture of apparel sales in the foreseeable future, because some apparel shopping is mall-based, and because of the factory outlet stores in Gilroy. Sales per square foot derived from several sources of industry benchmarks, including a Hinterliter de Lamas analysis of sales per square foot in California by store type, BizStats.com, and Urban Land Institute's *Dollars & Cents of Shopping Centers, 2004*. Analysis is limited to retail store types likely to be found in the proposed center (e.g., automobile dealers have been excluded). Also excludes all non-retail outlets (business and personal services) reporting taxable sales. Sales amounts rounded to nearest thousand dollars. Other Retail includes Photo Equipment, Musical Equipment, and Other Specialty.

Sources: Bay Area Economics 2005, based on information from the CA State Board of Equalization, 2000 U.S. Census, Association of Bay Area Governments, Urban Land Institute, BizStats.com, Home Depot and Lowe's 2004 Annual Reports, and Hinterliter de Lamas.

Demand from Population Growth. Table 10 shows an estimate of the growth in demand for retail space in key categories in the Target Trade Area. According to this estimate, the Target Trade Area is able to support approximately 107,000 square feet of new retail space in the selected categories between 2005 and 2010.

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Table 10: Additional Supportable Square Feet of Retail Space from Population Growth

| Store Category | Total Additional Sales | Capture | Captured Additional Sales | Average Sales per Square Foot | Additional Supportable SF |
|--|-------------------------------|----------------|----------------------------------|--------------------------------------|----------------------------------|
| Apparel | \$2,270,000 | 100% | \$2,270,000 | \$378 | 6,000 |
| General Merchandise/Drug | \$6,731,000 | 100% | \$6,731,000 | \$280 | 24,000 |
| Gifts, Art, Novelties | \$218,000 | 100% | \$218,000 | \$218 | 1,000 |
| Sporting Goods | \$525,000 | 100% | \$525,000 | \$175 | 3,000 |
| Florists | \$121,000 | 100% | \$121,000 | \$121 | 1,000 |
| Musical Equipment | \$245,000 | 100% | \$245,000 | \$245 | 1,000 |
| Stationery and Books | \$513,000 | 100% | \$513,000 | \$257 | 2,000 |
| Office, Store and School Supply | \$2,841,000 | 100% | \$2,841,000 | \$284 | 10,000 |
| Food Stores | \$8,010,000 | 100% | \$8,010,000 | \$381 | 21,000 |
| Eating & Drinking Places | \$5,225,000 | 100% | \$5,225,000 | \$523 | 10,000 |
| Home Furnishings and Appliances | \$1,951,000 | 100% | \$1,951,000 | \$390 | 5,000 |
| Building Materials | \$3,211,000 | 100% | \$3,211,000 | \$292 | 11,000 |
| Other Retail | \$3,176,000 | 100% | \$3,176,000 | \$265 | 12,000 |
| Total Additional Supportable Square Feet, 2010 | | | | | 107,000 |
| Notes: See Table 2 for population data. County per capita sales used as benchmark. Assumes 100 percent capture of sales from increased population growth. Sales per square foot derived from several sources of industry benchmarks, including a Hinterliter de Lamas analysis of sales per square foot in California by store type, BizStats.com, and Urban Land Institute's <i>Dollars & Cents of Shopping Centers, 2004</i> . Some sales per square foot averages represent weighted averages of several categories not disclosed due to confidentiality rules. Analysis is limited to retail store types likely to be found in the proposed center (e.g., automobile dealers have been excluded). Also excludes all non-retail outlets (business and personal services) reporting taxable sales. Sales amounts rounded to nearest thousand dollars. Other Retail includes Photo Equipment, Musical Equipment, and Other Specialty. Additional supportable square feet rounded to nearest thousand. | | | | | |
| Sources: Bay Area Economics 2005, based on information from the CA State Board of Equalization, 2000 U.S. Census, Association of Bay Area Governments, Urban Land Institute, BizStats.com, Home Depot and Lowe's 2004 Annual Reports, and Hinterliter de Lamas. | | | | | |

Total Additional Supportable Retail Square Footage. Table 11 sums the total sales and square footages for capture of existing leakage as well as from population growth through 2010. By category, sizes range from 3,000 square feet for gift/art/novelty stores to 65,000 square feet for office/store/school supplies. For general merchandise stores, the additional supportable square footage is 52,000 square feet, not enough for a large new general merchandise store, but more than the proposed Target expansion. There is estimated demand for 38,000 square feet of restaurant space, with the detailed analysis shown in Appendices G and H indicating that most of this demand is for eating and drinking places service some kind of alcohol (i.e., not fast food restaurants). In the building materials store category, there is estimated support for 56,000 square feet of new space, considerably less than the 140,000 square feet of potential store space in the project. Additionally, detailed analysis indicates that this support is mostly for hardware stores, paint, glass, and wallpaper stores, and plumbing and electrical supply stores, although to some extent a home improvement/building materials center could absorb this demand through store substitution on the part of consumers. For stationery and books, the total supportable square footage is estimated at 16,000 square feet, smaller than the 25,000 to 35,000 square feet typical of Barnes & Noble or Borders stores. In other categories, the estimates indicate potential support for some smaller apparel stores and also in the home furnishings and appliances store category,

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with the detailed analysis shown in Appendices G and H indicating that most of this demand is in the home furnishings store subcategory. The household appliances category, which includes retailers such as Best Buy, shows only an estimated 7,100 square feet of additional supportable space, far below the typical size for this store type. In total, there is estimated support for 378,000 square feet of additional retail space in Morgan Hill by 2010. The Proposed Project contains 577,650 square feet of retail space (excluding the movie complex).

Table 11: Summary of Additional Supportable Square Footage

| Store Category | Additional Sales from Leakage \$000 | Additional SF from Leakage | Additional Sales from Growth \$000 | Additional SF from Growth | Total Additional Supportable SF (a) |
|---|--|-----------------------------------|---|----------------------------------|--|
| Apparel | \$3,762 | 10,000 | \$2,270 | 6,000 | 16,000 |
| General Merchandise/Drug | \$6,975 | 28,000 | \$6,731 | \$24,000 | 52,000 |
| Gifts, Art, Novelties | \$690 | 2,000 | \$218 | \$1,000 | 3,000 |
| Sporting Goods | \$880 | 4,000 | \$525 | \$3,000 | 7,000 |
| Florists | \$787 | 3,000 | \$121 | \$1,000 | 4,000 |
| Musical Equipment | \$1,954 | 8,000 | \$245 | \$1,000 | 9,000 |
| Stationery and Books | \$3,905 | 14,000 | \$513 | \$2,000 | 16,000 |
| Office, Store and School Supply | \$15,180 | 55,000 | \$2,841 | \$10,000 | 65,000 |
| Food Stores | \$5,772 | 15,000 | \$8,010 | \$21,000 | 36,000 |
| Eating & Drinking Places | \$14,706 | 28,000 | \$5,225 | \$10,000 | 38,000 |
| Home Furnishings and Appliances | \$11,430 | 27,000 | \$1,951 | \$5,000 | 32,000 |
| Building Materials | \$11,510 | 45,000 | \$3,211 | \$11,000 | 56,000 |
| Other Retail | \$10,513 | 32,000 | \$3,176 | \$12,000 | 44,000 |
| Total Additional Retail Square Feet Supportable by Leakage and Growth through 2010 | | | | | 378,000 |
| Notes: Detail in Tables 9 and 10. (a) Rounded to nearest 1,000. Sources: Bay Area Economics 2005, based on information from the CA State Board of Equalization, 2000 U.S. Census, Association of Bay Area Governments, Urban Land Institute, BizStats.com, Home Depot and Lowe's 2004 Annual Reports, and Hinterliter de Lamas. | | | | | |

Demand for New Retail Space from beyond the Target Trade Area

The developers of the project have a stated goal to position this center as a “lifestyle center,” drawing patrons from a market area extending beyond that of the Target anchor store itself. Smaller than regional malls, built around open-air designs, and lacking traditional department store anchors, the lifestyle center is the current “state-of-the-art” in retail development. With nearly 130 in existence nationwide and approximately 30 planned over the next three years, there is considerable diversity in what developers describe as a lifestyle center. Lifestyle centers often feature plazas, fountains and other landscaping elements and attempt to recreate a village square, marketplace, or Main Street atmosphere. Layouts vary, with some developers placing retailers in a horseshoe configuration and others using building clusters. Lifestyle centers are open-air developments that attempt to create a pedestrian friendly environment.

Based on research by the International Council of Shopping Centers (ICSC), lifestyle centers were originally conceived of as a vehicle for growth in the specialty retail sector, a fact reflected in the current tenant mix of most lifestyle centers. Today, approximately three-quarters of tenants

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in lifestyle centers fall into the specialty retail category, making up 35 of the nearly 50 tenants in an average center. The top three specialty retail categories are women's ready to wear, family apparel, and home furniture and furnishings. At or near the bottom of the list are athletic shoe stores and automotive tool stores, not seen as a good fit for the image of a lifestyle center. After specialty retail, sit-down restaurants are the next most common lifestyle tenant, making up twelve percent of all lifestyle tenants, and averaging six per center. Other major tenant groups include fast food restaurants, personal services, personal care, and business services. Approximately one-third of lifestyle centers have movie theaters. Department stores are still relatively uncommon in lifestyle centers, making up less than one percent of all tenants. In lifestyle centers a combination of sit-down and fast-casual restaurants are an important draw. Entertainment uses are common in lifestyle centers. These include multiplex movie theaters, skating rinks, bowling alleys, bars, and clubs. Entertainment facilities help to make lifestyle centers into destinations and serve to extend operating hours.

In lifestyle centers opened during the past two years, large stores are dominated by four categories: books (particularly Borders and Barnes & Noble), sporting goods (e.g., Dick's Sporting Goods, Galyan's) home furnishings (e.g., Linens 'N Things) and family apparel (e.g., Old Navy). Overall, the top retailers in lifestyle centers by number of outlets are Chico's, Talbots, and Williams-Sonoma. For a complete list of the top ten lifestyle retailers, see Appendix I.

Lifestyle centers vary considerably in gross leasable area (GLA) from less than 100,000 square feet to over 1,000,000 square feet. The median GLA of all lifestyle centers is 325,000 square feet with most centers between 190,000 and 500,000 square feet. Recent centers tend to be larger. The median GLA of centers built since 2001 is 386,500 square feet with most ranging between 230,000 and 575,000 square feet. The trend toward larger retail centers is expected to continue in coming years, with the median GLA of proposed lifestyle centers reaching 500,000 square feet.

According to the (ICSC), the median age of the typical shopper over age 18 is 40 years of age at a lifestyle center. Compared to regional malls, lifestyle centers tend to draw fewer people in younger and older age groups. Sixty-eight percent of lifestyle center shoppers are between the ages of 25 and 54 compared to 59 percent at regional malls. Lifestyle center shoppers tend to be affluent, with a median household income just under \$85,000 nationwide. Compared to the U.S. population as a whole, these numbers are particularly high given that median household income was \$47,000 in 2003. The market areas for lifestyle centers tend to be quite large, drawing shoppers from a distance for the shopping experience they represent.

The lifestyle center closest to Morgan Hill is Santana Row in San Jose. Santana Row combines shopping, dining, entertainment, a hotel, and residences to create an urban shopping and living environment. Retail uses total 660,000 square feet, and include a range from typical lifestyle tenants such as Chico's and Ann Taylor to big box uses such as Best Buy and the Container Store. After a slow start due to the economic downturn and a major fire that delayed opening, Santana Row has rebounded considerably, with 92 percent of retail space leased as of September

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2004.¹⁵ Management estimates that sales are currently at \$600 per square foot, with restaurants at \$800 per square foot and retailers at \$500.

Because of the recent emergence of lifestyle centers and their continuing evolution, the size of market area necessary to support such a center varies considerably depending on tenant mix and size of center. There are approximately 1.45 million persons living within a 10 mile radius of Santana Row and 1.27 million within a 10 mile radius of Bay Street, another lifestyle center in Emeryville. By comparison, there are approximately 94,000 persons living within 10 miles of the Proposed Project site, and 456,000 within 15 miles.¹⁶

As currently configured, the Proposed Project includes uses atypical of a conventionally defined lifestyle center, and the site plan appears to be more conventional. Unlike Santana Row, Bay Street in Emeryville, or many lifestyle centers, the Proposed Project bears little resemblance to a “main street” layout, although it has walkways linking its major subcomponents in order to create a more pedestrian-friendly atmosphere. The Proposed Project does have entertainment and restaurant uses typical of lifestyle centers, with additional space that could potentially be used by lifestyle center-type tenants, in two inline shopping strips separated from each other and the two “big box” spaces by parking lot space. One of these strips is dominated by the proposed theater space. Thus the center as proposed may represent a mixed center type called a “hybrid center” that combines lifestyle center components with big box uses or an enclosed mall space.

The typical stores in lifestyle centers fall in several of the general categories of retail as shown in Table 9 above, with an emphasis on apparel and specialty retail. Since they are part of a larger category, they must differentiate themselves from and compete with other stores in the Lifestyle Trade Area. Of particular note are the factory outlet stores in Gilroy, which successfully draw shoppers from a broad region and skew apparel sales far above expected levels, making it difficult to assess demand for additional apparel stores regionally. Other competitive outlets in Gilroy include some of the tenants at the new Gilroy Crossing center, such as Barnes & Noble, Lane Bryant, and Pier 1 Imports.

The major lifestyle center use that is specifically designated in the site plan is the movie theater complex. This space comprises 63,200 square feet, suitable for an estimated 14 screens. Specialty grocery stores such as Trader Joe’s sometimes locate in these centers, but conventional supermarkets are not typical tenants. The restaurants evident on the site plan are mostly pads suitable in size and layout for fast food restaurants, but some of the other retail space could be utilized by larger sit-down restaurants to bring a wider variety of eating options to the center, or perhaps the pad spaces could be configured for sit-down restaurants. Because the other tenants in the Proposed Center have not been designated, this economic impact analysis assumes a more generic tenant mix based on the categories discussed in Table 9, using the design information provided by the site plan as a guide. As a result, the analysis focuses on demand from the Target Trade Area for potential tenants other than the movie theater complex, since at this time it cannot be assumed with certainty that the other tenants will have a broader regional draw. If the

¹⁵ http://retailtrafficmag.com/mag/retail_maxeduse/

¹⁶ 2004 population estimated from Claritas. May vary from other sources used in this report.

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Proposed Project succeeds in signing tenants fitting the upscale lifestyle center profile, they may draw shoppers from a larger area, lessening some of the impacts discussed here. However, the population base is spread over a broad geographic area and does not have the population density surrounding lifestyle centers elsewhere in the Bay Area.

Summary of Retail Sales Trends

Historic retail sales trends in south Santa Clara County can be seen as a “Tale of Two Cities,” with Morgan Hill’s retail sales trends in stark contrast to sales trends in nearby Gilroy. Morgan Hill’s retail sales have not kept pace with population, unlike Gilroy’s. Morgan Hill per capita retail sales are actually below countywide levels, a strong indicator of retail leakage. In contrast, Gilroy’s per capita sales are far above countywide levels, with the gap increasing over time, showing Gilroy’s strengthening position as a regional retail destination. Morgan Hill retail sales trends have matched the downward trend countywide of the last few years in the general merchandise, food store, building materials, and restaurant categories, although the opening of Home Depot in 2004 has led to a sharp increase in sales in the building materials store category. Sales data from 2004 also indicate a sharp drop in general merchandise store sales following the opening of Gilroy’s Costco early in 2004 and the Target and Kohl’s in Gilroy Crossing prior to the holiday shopping season that year. Gilroy has shown a steady increase in all of these categories, with the exception of food stores, where sales levels are more closely tied to the local population and its growth.

The Target Trade Area can support additional retail in most relevant retail categories for a large retail center, with potential capture of approximately \$88 million in sales leakages and an additional \$34 million in growth through 2010, supporting 378,000 square feet of new retail space. However, the additional sales in some categories, including building materials stores, bookstores, and home appliance stores, is not enough to support large-format national chain retail stores. One exception to this is office supply stores. The limitations of local demand in combination with the large size requirements for national retailers further exacerbates Morgan Hill’s weakness in competing with Gilroy, which has a larger and more quickly growing population base, and can more easily capture additional sales from San Benito County to the south.

The developers have stated that they seek to position this center as a “lifestyle center,” providing a shopping experience unique to Morgan Hill with a combination of entertainment, dining, and upscale tenants. With the presence of two big-box anchors, the entire center could be classified as “hybrid center” with lifestyle components combined with stores found in more conventional shopping centers. Such a center might draw from beyond the Target Trade Area, but would have to draw from a very broad area to match the population base of two major existing lifestyle centers in the Bay Area, Santana Row and Bay Street. Since the other tenants in the Proposed Center have not been designated, this economic impact analysis assumes a more generic tenant mix, with many of the tenants of unspecified categories. With the exception of the movie theater complex, the analysis assumes that demand will come from the Target Trade Area for potential tenants other than the movie theater complex, since at this time it cannot be assumed with certainty that the other tenants will have a broader regional draw. If the Proposed Project succeeds in signing tenants fitting the upscale lifestyle center profile, they may attract significant numbers of shoppers from a larger area, lessening some of the impacts discussed here.

Impacts on Competing Retail Nodes

This chapter compiles an inventory of competing retail nodes, and using the information on general sales volumes by store type and the supportable square footage analysis, estimates the impacts of the Proposed Project on sales of existing retailers in Morgan Hill. The analysis covers the major uses considered for the Proposed Project as well as considering other types retail that might locate in the Proposed Project.

Inventory of Competitive Outlets

Currently, the only tenant designated by name in the Proposed Project is Target. Other potential uses that can be discerned from the site plan include a large home improvement store, a movie theater complex, and restaurants. Additionally, the site plan shows a grocery store and a fuel station as alternative uses. BAE has identified and inventoried major competitors for the Proposed Project in the general merchandise, supermarket, home improvement center, and movie theater categories. Restaurants and gas stations have not been inventoried. Figure 11 shows the competing retail nodes and primary competitive outlets in Morgan Hill.

